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ABSTRACT

Various aspects of tax allowances for the expenses of higher education, and alternative subsidies are analyzed. A tax allowance for education is presented as one way to give more financial relief to middle-income families. The current distribution of student aid among income groups is discussed and data on college enrollment rates, family incomes, and college charges are examined. A general discussion of education tax allowances including consideration of the various forms such allowances can take and a brief legislative history of Senate-approved measures is presented. A set of criteria or standards are suggested for comparing different student aid subsidies and these criteria are used to evaluate alternative approaches to providing student aid for middle-income families. The appendices contain a brief description of tax expenditures and other student aid programs and a discussion of education tax allowances and tax equity. (SPG)

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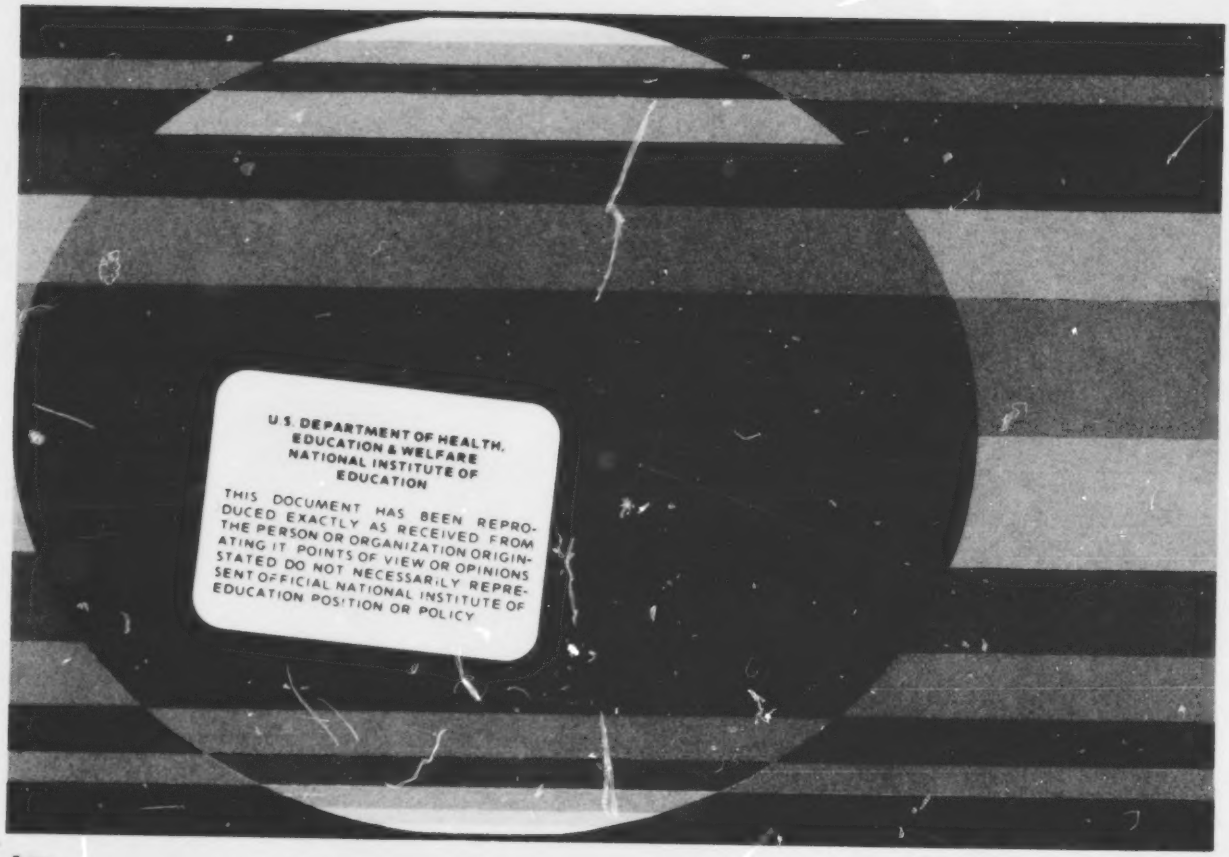
BACKGROUND PAPER

Federal Aid to Postsecondary Students: Tax Allowances and Alternative Subsidies

January 1978



HE 019 789

Congress of the United States
Congressional Budget Office
Washington, D.C.

PREFACE

For nearly twenty years, tax allowances for the expenses of higher education have been proposed in the Congress, but none has been enacted into law. In light of Congressional concern about the ability of middle-income families to afford a higher education for their children, Congressional interest in education tax allowances is likely to persist. As it continues to deliberate about how to provide more aid to students, the Congress may want to consider alternatives to education tax allowances.

Federal Aid to Postsecondary Studeuts is intended to assist in deliberations of this subject by analyzing various aspects of tax allowances for education and alternative subsidies. The study was prepared in response to a May 1977, request from Chairman William D. Ford of the House Committee on Education and Labor. In accordance with the Congressional Budget Office's mandate to provide nonpartisan analysis of issues before the Congress, the study offers no recommendations.

Frank S. Russek, Jr., of CBO's Tax Analysis Division prepared the report with assistance from Richard Wabnick of the Human Resources Division. A number of other people within CBO gave valuable comments and suggestions, including Charles Davenport, David S. Mundel, and James Verdier. In addition, many people outside of CBO helped in the preparation of the report, including Harry Boissevain, David W. Breneman, Rosalind Bruno, Anthony P. Carnevale, Jean Frohlicher, William Goggin, Thomas R. Jolly, John Karr, Donald W. Kiefer, John K. McNulty, Dan Morrissey, Darla Schecter, Eugene Steuerle, Stanley S. Surrey, Ira Tannenbaum, and Peter K. Voigt. The paper was prepared for publication under the supervision of Johanna Zacharias, Martha A. Roberts edited the manuscript, and Alda Seubert and Shirley Hornbuckle typed it.

Alice M. Rivlin
Director

January 1978

CONTENTS

		Page
PREFACE		iii
SUMMARY		xi
CHAPTER I.	INTRODUCTION	1
CHAPTER II.	THE BURDEN OF COLLEGE COSTS ON STUDENTS AND THEIR FAMILIES	3
	The Distribution of Federal Student Aid	4
	Enrollment Changes During the 1967-1976 Decade	8
	Growth of College Costs, Family Income and Student Aid	11
CHAPTER III.	EDUCATION TAX ALLOWANCES	15
	Forms of Education Tax Allowances	15
	Further Design Consideations of Education Tax Allowances	17
	Brief Legislative History of Education Tax Allowances	20
CHAPTER IV.	CRITERIA FOR COMPARING ALTERNATIVE SUBSIDY PROGRAMS	24
	Cost	24
	Distributional Efficiency	25
	Fairness and Equity	26
	Maintaining Institutional Diversity	27
	Ease of Administration	29
	Budget Visibility and Controllability	30

		Page
CHAPTER V.	ALTERNATIVE PROGRAMS OF AID FOR MIDDLE-INCOME STUDENTS	32
	Tax Credit or Credit/Deduction Options	32
	Basic Educational Opportunity Grants .	38
	Student Loans	43
	Loans to Parents	48
	Tax Deferrals for Education Expenses .	51
APPENDIX A.	BRIEF DESCRIPTION OF TAX EXPENDITURES AND OTHE STUDENT AID PROGRAMS	59
APPENDIX B.	EDUCATION TAX ALLOWANCES AND TAX EQUITY	65

TABLES

		Page
TABLE 1.	DISTRIBUTION OF AID TO STUDENTS BY INCOME CLASS, FISCAL YEAR 1977	5
TABLE 2.	PERCENTAGE DISTRIBUTION OF STUDENT AID BY INCOME CLASS, FISCAL YEAR 1977	6
TABLE 3.	PERCENTAGE OF 18- TO 24-YEAR-OLD DEPENDENT FAMILY MEMBERS ENROLLED FULL TIME IN COLLEGE	9
TABLE 4.	COLLEGE COSTS, FAMILY INCOME, STUDENT AID, AND THE GENERAL PRICE LEVEL	12
TABLE 5.	SIZE AND DISTRIBUTION OF BENEFITS UNDER A NONREFUNDABLE TAX CREDIT OF $250 COSTING APPROXIMATELY $1.7 BILLION IN FISCAL YEAR 1978	34
TABLE 6.	SIZE AND DISTRIBUTION OF BENEFITS UNDER A $200-CREDIT/$1,000 DEDUCTION COSTING APPROXIMATELY $1.9 BILLION IN FISCAL YEAR 1978	35
TABLE 7.	DISTRIBUTION OF ADDITIONAL BENEFITS FROM RAISING THE MAXIMUM BEOG AWARD TO $2,100 AND LOWERING THE FAMILY CONTRIBUTION RATE FROM 30 TO 20 PERCENT ON DISCRETIONARY INCOME ABOVE $5,000	40
TABLE 8.	DISTRIBUTION OF BENEFITS OF A TAX DEFERRAL PLAN PERMITTING POSTPONEMENT OF $1,500 OF TAXES ANNUALLY PER STUDENT	53
TABLE A-1.	MAJOR STUDENT AID IN THE FORM OF TAX EXPENDITURES AND FEDERAL OUTLAYS	60
TABLE B-1.	COMPARATIVE EFFECTS OF TAX CREDITS AND TAX DEDUCTIONS ON TAXPAYER EQUITY	68

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21-200 O - 78 - 2

SUMMARY

Tax allowances for the expenses of higher education have been considered in the Congress since the 1950s, but no proposal has ever passed both Housses. Proponents of tax allowances for education argue in particular that more assistance than middle-income families now get is needed. The Congress' interest in such allowances reflects a continuing concern about these families' ability to finance higher education without more aid from the federal government.

In fiscal year 1977, the federal government provided $8.5 billion in student aid in the form of direct outlays and tax expenditures. Students from families with incomes between $10,000 and $20,000 (accounting for 33 percent of all students) received 36 percent of this sum although they received a smaller share--21 percent--of the $2.3 billion disbursed under programs based on need.

The enrollment rate of dependents between ages 18 and 24 from middle-income families has declined somewhat since 1967. In recent years, however, the rate has begun to go back up. How much rising college costs account for lower enrollment rates among middle-income students in the past decade is unclear since median family income has risen faster than average college costs. Between 1967 and 1976, charges for college tuition and other fees, plus room and board, rose about 75 percent. In comparison, median family income increased almost 89 percent. The incomes of those families whose incomes were in the top 20 percent rose 95 percent. Perhaps certain factors other than cost help explain enrollment rate declines. Such factors may include reduced requirements for military manpower, families' preferences to spend money on items other than education, the choice of whether to work or study, or the diminishing rate of return on the investment in higher education.

A tax allowance for education is one way to give more financial relief to middle-income families. It could take the form of a credit, a deduction, or a deferral. Any of these three tax allowances would aid middle-income families although none would be especially effective in concentrating aid on this group. A number

of nontax alternatives could also aid middle-income families. Some of these may be more consistent with present tax and education policy. In addition, these might lower budgetary cost.

Five alternatives are analyzed in this report:

- o Tax credit or credit/deduction options,
- o Basic Educational Opportunity Grants,
- o Student loans,
- o Loans to parents, and
- o Tax deferrals.

CRITERIA FOR EVALUATION OF STUDENT AID PROGRAMS

Five criteria are used to evaluate the options considered in this report:

- o Cost and distributional efficiency--How much does a program cost? What fraction of total benefits accrues to middle-income students or their families?
- o Fairness and equity--Do all recipients get the same amount of benefits, or are benefits related to the income of recipients?
- o Maintaining institutional diversity--How does the subsidy affect the absolute and relative cost differences between public and private institutions?
- o Ease of administration--Does a subsidy program have few or many eligibility restrictions? Is the agency that administers the program experienced at making the required evaluations?
- o Budget visibility and controllability--Is the subsidy program subject to annual review in the budgetary process? Are its outlays subject to control?

COST, DISTRIBUTIONAL EFFICIENCY, AND EQUITY OF ALTERNATIVE PROGRAMS OF AID FOR MIDDLE-INCOME STUDENTS

If the Congress decides to concentrate more aid on middle-income families, major consideration should be given to how best to channel adequate and equitable assistance to the target group. In assessing the options with respect to their costs, distributional efficiency, and fairness, this report draws the conclusions discussed below.

Tax Credit or a Credit/Deduction Option

Two possible tax allowances for higher education expenses are a nonrefundable tax credit of $250 per student (prorated for part-time students) and an option for taxpayers to choose between a nonrefundable $200 credit or a $1,000 deduction for tuition, books, fees, supplies, and equipment.

A tax credit plan of this sort would cost the U.S. Treasury about $1.7 billion in the first year, while the credit/deduction option would cost roughly $1.9 billion. The tax credit plan would be more efficient than the credit/deduction option in focusing aid on middle-income families. About 49 percent of the benefits from the credit-only plan would go to families with incomes between $10,000 and $25,000, while only 42 percent of the benefits from the credit/deduction option would go to this income group. The distribuiton of these benefits could be concentrated in low- and middle-income groups by reducing or eliminating the subsidy on income levels above $25,000. The subsidy could also be reduced for the first student a family has enrolled in school.

The credit/deduction option would extend larger benefits to those with higher marginal tax rates. The credit-only plan would offer the same amount of benefits to all qualified students with family tax liabilities of at least $250 and thus might be considered more equitable.

Basic Educational Opportunity Grants

Additional federal aid could be provided to middle-income students by liberalizing the Basic Educational Opportunity Grants (BEOG) program. The benefits of the program--now aimed mostly at

low- and moderate-income students--could be extended to those in somewhat higher income groups by raising the maximum award to $2,100 and by reducing from 30 percent to 20 percent the fraction of discretionary income above $5,000 that a family is expected to contribute toward higher education financing. (The Education Amendments of 1976 raised the maximum award from $1,400 to $1,800, but appropriations for fiscal year 1978 effectively imposed a ceiling of $1,600.)

Such changes in the BEOG program, costing about $800 million, would benefit approximately 490,000 more students in the middle-income class ($10,000 to $25,000). This plan would provide about 72 percent of the additional benefits to middle-income students and thus would rank much higher in terms of distributional efficiency than the tax credit and credit/deduction plans, which focus less than half of total benefits on fmailies with incomes between $10,000 and $25,000.

The average additional award for those brought into the program as a result of the described program changes would vary with the family income of the recipient; it would be larger for middle-income families than for low-income families. In this respect, the distribution of benefits resembles that of the credit/deduction option. Those who maintain that education subsidies should be distributed equally among all recipients might therefore view this option as somewhat less equitable than the tax credit, which provides about the same benefit for all students with family tax liabilities of at least $250.

Guaranteed Student Loans

Before 1976, eligibility for some federal interest subsidies on guaranteed student loans was lost when adjusted family income reached $15,000. The Education Amendments of 1976 raised this ceiling to $25,000 (equal to about $31,000 of adjusted gross income), thus expanding eligibility to about 85 percent of all students; the amendments also increased from $10,000 to $15,000 the total amount that a student can borrow for undergraduate and graduate training.

The additional benefit to middle-income families resulting from the 1976 amendments probably could be enhanced most by providing larger incentives for banks to include more guaranteed

student loans in their loan portfolios. Banks might be willing to provide more funds if their net rate of return were improved by reducing the costs of complying with administrative procedures and by increasing the federally subsidized interest payments to banks.

The federal cost of an expanded Guaranteed Student Loan Program (GSLP) is difficult to estimate since it depends on the additional volume of student loans as well as on the federal interest and default payments per dollar of loans. Also the distributional efficiency of this way of aiding middle-income families is difficult to quantify. Banks not only have wide discretion in determining the amount of GSLs they will make but also select the individuals to whom such loans will be made. Middle-income families, however, might benefit disproportionately, especially if banks think middle-income borrowers are good risks.

Since all qualified students are eligible for the same amount of loan, an expanded GSLP probably would be considered equitable by those who maintain that education subsidies should be distributed equally among all recipients.

Loans to Parents

Another possible way to ease the liquidity problems of middle-income families would be to establish a guaranteed loans-to-parents program. Such a program might not share the deficiencies of the GSLP--high default rate for example--and therefore might prove more attractive to private lenders.

The terms of a guaranteed loans-to-parents program might include a loan limit of as much as $5,000 per student per year, a repayment period of between 5 and 10 years, and an interest rate of between 8 percent and 10 percent (perhaps varying with the length of the repayment period).

The cost to the Treasury of a guaranteed loans-to-parents program would depend upon the volume of loans made, the default rate on these loans, and the size of any necessary federal supplemental interest payments to banks. The federal costs per dollar of loans made to parents are likely to be lower than that of the GSLP because of smaller federal interest subsidies and a lower default rate. The percentage of loans to parents that would go to

middle-income families would depend upon which families apply for loans and to whom banks decide to lend.

The equity of this program--with same loan amounts available to all families--would likely rank high among those who believe that education subsidies should be distributed equally among recipients.

Tax Deferrals

Higher education loans can be provided through the tax system by allowing taxpayers to postpone a portion of their tax payments. For example, a tax deferral equal to education expenses not exceeding $1,500 annually might be permitted each year a student is in school. Repayments could be made in 10 equal annual installments, beginning one year after graduation. An interest rate of 7 percent (equal to that on guaranteed student loans) could be charged to cover the Treasury's borrowing costs, or a lower interest rate could be charged to provide a larger subsidy.

A tax deferral plan of this sort would have an initial cost of about $8.8 billion, but the annual net cost to the Treasury would decline substantially as taxpayers begin to repay their deferred taxes. The program would be less efficient than an expanded Basic Educational Opportunity Grants program in distributing aid to middle-income families since only 53 percent of the benefits would go to families earning between $10,000 and $25,000.

Only those with tax liabilities as large as the highest permitted deferral would benefit fully from this program. Large tax deferrals would therefore benefit those in high tax brackets more than those in low tax brackets. This distributional outcome might not be satisfactory to those who maintain that education subsidies should be distributed equally among all taxpayers or be distributed on the basis of need.

OTHER CRITERIA APPLIED TO STUDENT AID PROGRAMS

Applying the remaining tests to the alternative programs shows a number of common threads (and a few anomolies) running through the tax alternatives--credits, deductions, deferrals--and through the nontax options--guaranteed loans to either students or parents and an expanded BEOG program.

Maintaining Institutional Diversity

Tax Options. Students would generally get the same amount of aid whether they attend a public institution or a private one (in the case of tax deferrals this applies if the college costs at least equal the deferral). The absolute cost difference between public and private schools, therefore, would not be changed for most students. Tax programs, however, would generally represent a greater percentage reduction of costs at public institutions and thus would magnify the relative cost difference between public and private schools. The increase in the relative price of private institutions might put them at a disadvantage.

Nontax Options. For loan programs, the short-run impact on the competitive balance between public and private institutions depends upon the share of costs parents or students borrow; excepts for interest payments, loan programs would not change the long-run cost differences between public and private schools. Changes in the BEOG program generally would lower the cost of attending public institutions by a greater proportion than the cost of attending private ones, possibly putting private institutions at a disadvantage.

Ease of Administration

Tax Options. Both the credit-only and the credit/deduction options would be fairly easy to administer because few eligibility restrictions are imposed on tax programs and only a small fraction of tax returns are audited. Tax deferrals with long payback periods would not be as easily administered because records and accounts would have to be maintained for about 15 years.

Nontax Options. The administrative burden of BEOGs includes verifying a high share of claims to detect fraud and abuse. Student loan programs have been beset by high default rates and delinquency. A loan program for parents could prove easier to administer than the student program because of the likelihood of fewer defaults and greater ease in collecting overdue payments.

Budget Visibility and Controllability

Tax Options. These would rank low in visibility and controllability. Like other tax expenditures, these tax allowances would

21-200 O - 78 - 3

SUMMARY OF ANALYSIS OF ALTERNATIVE WAYS TO PROVIDE ASSISTANCE TO MIDDLE-INCOME STUDENTS

Program	Criteria	
	Percent of Benefits Going to $10-25,000 Income Group	Distribution of Average Benefits
Nonrefundable $250 tax credit ($1.7 billion) a/	49	Equal for full-time students with sufficient family tax liability
Liberalized Basic Educational Opportunity Grants Program ($800 million) a/	72	Increase goes largely to middle-income students
Expanded Guaranteed Student Loan Program b/	Uncertain	Potentially equal for all eligible students
Loans-to-Parents Program c/	Uncertain	Potentially equal for all families with students
$1,500 Tax Deferral ($8.8 billion) a/	53	Equal for full-time students with sufficient family tax liability

a/ Initial first-year cost to the Treasury.
b/ Cost estimate not available; federal cost for fiscal year 1977 was $447.6 million (volume of loans was $1.47 billion.
c/ Cost estimate not available, but federal cost would likely be lower than costs for Guaranteed Student Loan Program.

(Summary Table Continued)

Criteria		
Impact on Public & Private Colleges	Ease of Administration d/	Budget Visibility and Controllability
Absolute cost difference unchanged; relative cost of private schools increased	Medium-High	Low
Absolute cost difference generally unchanged: relative cost of private schools generally increased.	Medium	High
Variable	Medium	Medium
Variable	Medium-High	Medium
Absolute cost difference generally unchanged; relative cost of private schools generally increased in short run	Low-Medium	Low

d/ In general, programs with few eligibility limitations are easier to administer.

not be subject to the same amount of review and scrutiny that is given most direct outlay programs. Moreover, they are entitlement programs that provide benefits to all who qualify and therefore are not subject to fixed ceilings on appropriations. The magnitude of tax deferrals tends to be less visible as repayments offset new deferrals.

Nontax Options. Loans are moderately visible in the budgetary process but are not very controllable. Unlike tax expenditures, federal outlays for such programs are subject to annual review. But because they are entitlements, loan programs are less controllable than other direct spending programs whose costs can be limited by the budgetary process. The BEOG program, in addition to being fairly visible, is also controllable through the appropriations process. Generally, however, when a reduction in the average individual award would have been required to stay within the initial appropriation ceiling, supplemental appropriations have been granted.

CHAPTER I. INTRODUCTION

The issue of tax allowances for the personal costs of higher education deserves analysis for at least three reasons. First, the matter has been considered in the Congress for many years, and interest in it remains high. Second, proposals for education tax allowances are gaining more support as Congressional concern about the ability of some families--particularly middle-income families--to finance their children's higher education expenses grows. Third, the issue is representative of many others in which the Congress must decide whether the tax structure is an appropriate mechanism for providing a subsidy.

Education tax allowances have not yet been put to a vote in the House of Representatives. 1/ In 1967 the Senate passed an amendment that would have provided a tax credit for certain higher education expenses. Similar action was taken by the Senate in 1969, 1971, twice in 1976, and again in 1977. At no time, however, have these amendments gone beyond conference committees. 2/

Concern about the ability of middle-income families to provide a higher education for their children has driven much of the effort to enact an education tax allowance. From time to

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1/ In the Second Concurrent Resolution on the Budget for Fiscal Year 1978, however, the budgetary targets adopted allowed $175 million for possible passage of an education tax allowance. See Congressional Record, daily ed., September 8, 1977, pp. H9028-30, and September 9, 1977, pp. S14510-16. Also, hearings on college tuition tax credits were held by the House Budget Committee's Task Force on Tax Expenditures, Government Organization and Regulation (April 28 and May 12, 1977). See Report on Hearings before the Task Force on Tax Expenditures, Government Organization and Regulation on College Tuition Tax Credits, House Committee on the Budget, 95 Cong. 1 sess. (Committee Print 95-12, November 1977).

2/ For a brief description of these amendments, see Chapter 3.

time, this concern has been heightened by reports that the college enrollment rate for children from middle-income families is declining and that inflation-induced increases in college costs may become so large that the average family will not be able to afford the expenses of college. Reports of this sort stimulate interest in providing more student aid for those who benefit relatively little from existing federal subsidies for higher education that are based on need. Such interest appears to be on the rise.

If the Congress decides to provide more student aid for middle-income families, it may be useful to consider alternatives to education tax allowances. Some other form of subsidy may be more consistent with tax policy and education policy and more effective in providing assistance to students and their families at lower budgetary costs.

The analysis that follows is designed to help in the evaluation of education tax allowances as a form of aid for middle-income families. It does not address the more fundamental issues of whether additional federal funds should be spent on higher education 3/ and, if so, whether education policy objectives are best served by focusing more aid on middle-income families. To provide a better understanding of the problems facing middle-income families, Chapter II briefly discusses the current distribution of student aid among income groups and examines data on college enrollment rates, family incomes, and college charges. Chapter III presents a general discussion of education tax allowances, including consideration of the various forms such allowances can take and a brief legislative history of Senate-approved measures. In Chapter IV a set of criteria or standards is suggested for comparing different student aid subsidies. Then in Chapter V these criteria are used to evaluate alternative approaches to providing student aid for middle-income families.

3/ For a discussion bearing on this issue, see John K. McNulty, "Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Personal Costs of Higher Education," California Law Review, vol. 61 (January 1973), pp. 1-80.

CHAPTER II. THE BURDEN OF COLLEGE COSTS FOR STUDENTS AND THEIR FAMILIES

The basic goal of most proposals for education tax allowances is to provide financial relief to middle-income families, although education subsidies may serve broader objectives, such as insuring equal access to higher education and maintaining the financial viability of higher education institutions. 1/ Although all families are affected by rising college fees, middle-income families seem especially burdened since they receive relatively little assistance from the needs-tested higher-education aid programs focused on low- and moderate-income groups and since they lack the financial resources available to high-income families.

Data from the Bureau of the Census suggest that the college enrollment rate for 18- to 24-year-old dependents of middle-income families has fallen somewhat over the past decade. 2/ This decline is often attributed to the financial pressures imposed by soaring college costs, although other factors, such as reduced

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1/ For a discussion of various goals that may be served by education subsidies, see Congressional Budget Office, Post-secondary Education: The Current Federal Role and Alternative Approaches (February 1977), and John K. McNulty, "Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Higher Education," California Law Review, vol. 61 (January 1973), pp. 1-80.

2/ U.S. Bureau of the Census, Current Population Reports, Series P-60, "School Enrollments--Social and Economic Characteristics of Students, October 1976" (forthcoming).

military manpower requirements, declining rates of return from a college education, 3/ family preferences for noneducation purchases, and simply the decision by some to work rather than study, also may have contributed. The extent to which enrollment rates have dropped as a result of rising college costs is unclear since family incomes in general have risen faster than college charges.

THE DISTRIBUTION OF FEDERAL STUDENT AID

In fiscal year 1977 the federal government provided about $8.5 billion of student aid in the form of direct spending programs and tax expenditures. Fifty-two percent of this aid benefited self-supporting students 4/ and students from families earning less than $10,000 annually, groups that accounted for 29.3 percent of total student enrollment. Students from families earning between $10,000 and $20,000 received about 36 percent of the aid and represented 32.5 percent of all students. The remaining funds went to families earning more than $20,000.

Tables 1 and 2 show the distribution of federal aid provided through various existing tax expenditures, direct grants (including payments for specified work), loans, and loan guarantees. Federal direct student aid programs, for the most part, have been designed to expand access to higher education for those with lower incomes. 5/ In contrast, most tax expenditures that provide student aid have not been designed specifically to do so;

3/ Changes in the rates of return from a college education are examined in Richard B. Freeman, "The Decline in the Economic Rewards to College Education," The Review of Economics and Statistics, vol. 59 (February 1977) pp. 18-29.

4/ Most self-supporting students have annual incomes below $10,000.

5/ For a discussion of current education policy goals, see Congressional Budget Office, Postsecondary Education: The Current Federal Role and Alternative Approaches, Budget Issue Paper, February 1977.

TABLE 1. DISTRIBUTION OF AID TO STUDENTS BY INCOME CLASS, FISCAL YEAR 1977, IN MILLIONS OF DOLLARS

Program	(Dollars in Thousands) Amount to Family Supported Students (Grouped by Adjusted Gross Family income) 0-10	10-20	20+	Self-supporting Students	Total
Tax Expenditures					
Exemption for student dependence	114	372	229	g/	715 a/
Exclusion of fellowships and scholarships	134	70	16	g/	220 a/ b/
Exclusion of G.I. Bill education benefits	143	32	15	g/	190 a/ b/
Exclusion of student social security benefits	64	23	13	g/	100 a/
Outlays for Major Student Aid Programs					
Basic Educational Opportunity Grants	777	230	c/	432	1,439 d/
Supplemental Educational Opportunity Grants	140	52	2	54	248 d/
Work/study programs	168	97	21	72	358 d/
National Direct Student Loans	106	109	30	50	295 d/
Guaranteed student loans	188	238	22	g/	448 b/ d/ e/
G.I. Bill education benefits	1,304	1,463	413	g/	3,180 f/
Social security student benefits	694	398	193	g/	1,285 f/
Total	3,832	3,084	954	608	8,478
	(Students in Thousands)				
Distribution of All Students b/ f/	3,370	3,738	4,392	g/	11,500

a/ Emil Sunley, "Federal and State Tax Policies," paper prepared for the Brookings Institution Conference on "Public and Private Higher Education," November 11-12, 1977.
b/ Includes self-supporting students.
c/ Amount insignificant.
d/ Budget Office, U.S. Office of Education.
e/ Includes interest payments of $305 million and default payments of $142.6 million.
f/ CBO estimate.
g/ Incorporated under other headings.

21-200 O - 78 - 4

TABLE 2. PERCENTAGE DISTRIBUTION OF STUDENT AID BY INCOME CLASS, FISCAL YEAR 1977 a/

Program	(Dollars in Thousands) Adjusted Gross Family Income 0-10	10-20	20+	Self-supporting Students
Tax Expenditures a/ b/				
Exemption for student dependence	16	52	32	c/
Exclusion of fellowships and scholarships	61	32	7	c/
Exclusion of G.I. Bill education benefits	75	17	8	c/
Exclusion of Student social security benefits	64	23	13	c/
Outlays for Major Student Aid Programs b/				
Basic Educational Opportunity Grants	54	16	d/	30
Supplemental Educational Opportunity Grants	56	21	1	22
Work/study programs	47	27	6	20
National Direct Student Loans	36	37	10	17
Guaranteed student loans a/	42	53	5	c/
G.I. Bill education benefits a/	41	46	13	c/
Social security student benefits	54	31	15	c/
Total	45.2	36.4	11.2	7.2
Distribution of All Students a/ b/	29.3	32.5	38.2	c/

a/ Includes self-supporting students.
b/ CBO estimate.
c/ Incorporated under other heading.
d/ Amount insignificant.

they have resulted instead from legislation and rulings concerned primarily with issues of tax policy. 6/

Tax expenditures provide direct assistance to students and their families in two ways. First, the tax law allows a student to be claimed as a dependent even if the student has an adjusted gross income greater than the $750 ceiling for nonstudents. Second, no taxes are imposed on income received in the form of scholarships, fellowships, student social security benefits, or education benefits under the G.I. Bill. These exemptions and exclusions lower taxable income to which progressive tax rates are applied. Thus they are worth more to taxpayers with high marginal tax rates than to those with low marginal tax rates. 7/

Other tax expenditures (not shown in Tables 1 and 2) assist students indirectly by providing aid to institutions. These include: the charitable deduction for contributions to schools, the exclusion of unrealized capital gains on these gifts and bequests, the deduction of state and local taxes used for higher education, and the exemption of interest on state and local borrowing for education purposes. The U.S. Department of the Treasury has cited figures showing that these tax expenditures totaled $2.6 billion in fiscal year 1977. 8/

As shown in Tables 1 and 2, except for guaranteed student loans and G.I. Bill education benefits, direct federal student aid programs concentrate funds on students in low- and moderate-

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6/ See John C. Chommie, The Law of Federal Income Taxation (Second Edition) (West Publishing Company, 1973), pp. 52, 62-66, 220.

7/ In the case of the exemption for student dependents, a $35 personal tax credit is also granted. This tax saving is the same for all taxpayers in terms of after-tax income but is worth more to high-income taxpayers in terms of before-tax income. For more discussion of this point, see Chapter III, footnote 3.

8/ Emil Sunley, "Federal and State Tax Policies," paper prepared for the Brookings Institution Conference on "Public and Private Higher Education," November 11-12, 1976, incorporated in

income groups. (Appendix A outlines the major student aid programs.) This distribution results because all of these other programs, except for social security, are needs-tested with the definition of financial need taking into account college costs as well as family income. Although student social security benefits are not needs-tested, benefits are reduced if the parents of recipients or recipients who are surviving dependents earn more than specified maximums. Because the Guaranteed Student Loan Program and G.I. Bill education benefits are not needs-tested, a greater proportion of benefits from these programs accrue to middle-income students.

ENROLLMENT CHANGES DURING THE 1967-1976 DECADE

While the overall college enrollment rate for dependent 18- to 24-year-olds has not changed much between 1967 and 1976, the enrollment rate for students from middle-income and high-income families has declined, especially when compared to the somewhat increased enrollment rate for low-income students. 9/ Enrollment rates for all income groups, however, have risen recently from the 1973-1974 low point, particularly for those in the middle-income classes.

Table 3 and the Figure show that the overall enrollment rate for dependent family members rose during the late 1960s, reflecting in part the decision by some males to enroll in college rather than to join the military. Between 1969 and 1974 the overall enrollment rate declined somewhat, reflecting mainly a drop in the enrollment rate for men, with that of women remaining fairly stable. After 1974, however, the enrollment rate for 18- to 24-year-olds rose again, largely reflecting substantial increases in the enrollment of women. 10/

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testimony of Assistant Secretary of the Treasury for Tax Policy, Laurence N. Woodworth, in College Tuition Tax Credits, Hearings before the House Budget Committee Task Force on Tax Expenditures, Government Organization and Regulation, 95: 1, p. 14.

9/ Bureau of the Census, "School Enrollments."

10/ For a male-female breakdown of individual student enrollment rates, see Bureau of the Census, "School Enrollments."

TABLE 3. PERCENT OF 18- TO 24-YEAR-OLD DEPENDENT FAMILY MEMBERS a/ ENROLLED IN COLLEGE, BY FAMILY INCOME, b/ OCTOBER 1967 TO OCTOBER 1876

	Percent Enrolled									
Family Income	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
$ 0-$ 8,525	20.0	22.5	24.8	20.8	22.8	22.6	20.1	20.3	23.5	22.4
$ 8,525-$17,050	37.9	38.5	38.8	36.6	35.4	34.2	31.2	31.7	35.1	36.3
$17,050-$25,575	51.9	50.7	50.6	48.4	46.4	44.2	42.7	41.4	45.4	47.5
$25,575+	68.3	63.0	65.2	61.7	61.8	56.9	56.6	57.5	59.6	58.2
All income groups	39.1	39.7	41.3	39.1	38.9	37.8	36.6	36.2	38.7	38.8

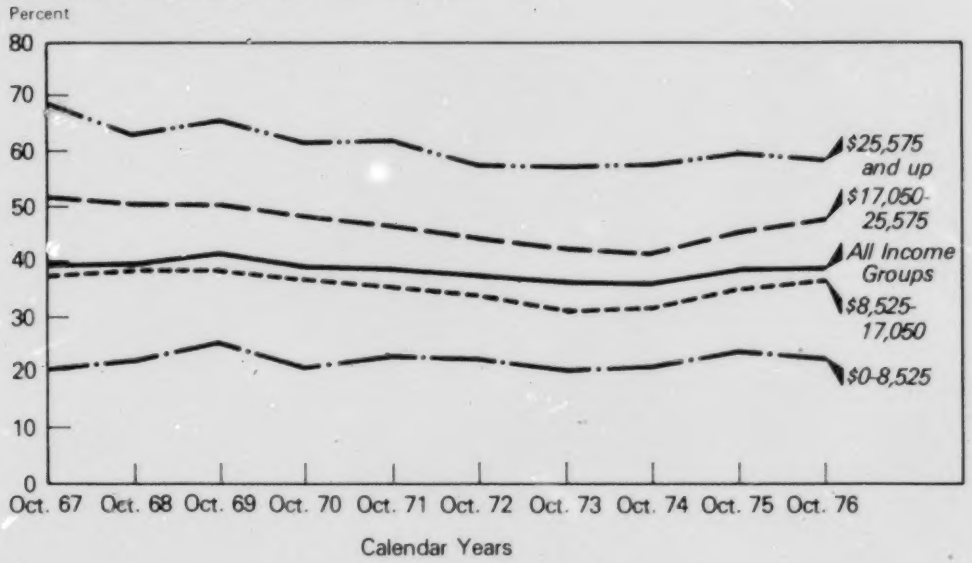
SOURCE: CBO calculations based on data supplied by the Census Bureau.

a/ A dependent family member is a relative of the primary family head other than the wife.

b/ Family income in 1976 dollars, civilian noninstitutional population.

Figure

Percent of 18-24-Year-Old Dependent Family Members[a] Enrolled in College, by Family Income[b], October 1967 to October 1976



a/ A dependent family member is a relative of the primary family head other than the wife.
b/ Family income in 1976 dollars for civilian noninstitutional population.

Table 3 and the Figure also indicate how the pattern of enrollment rates has varied by income class (adjusted for inflation) 11/ in recent years. The lowest and highest income groups

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11/ Failure to adjust enrollment data for the effect of inflation on family income can produce misleading conclusions. Enrollment decisions are based in part on what a family can afford, and this in turn is affected by inflation. Families earning $10,000 or $20,000 today are less well-to-do than families

($0-$8,525 and $25,575-plus) showed declines of roughly 10 percent between 1969 (the peak year) and 1976, while the enrollment rates for the two middle-income groups fell somewhat less--6 percent. Since 1974 the percentage increase in the enrollment rate for the two middle-income classes ($8,525-$17,050 and $17,050-$25,575) has been more than twice as large as the growth of enrollment rates for 18- to 24-year-olds in general.

GROWTH OF COLLEGE CHARGES, FAMILY INCOME, AND STUDENT AID

Increases in college costs can influence the decision whether to attend college or not. It is unclear, though, to what extent enrollment rates have been affected by increases in college tuition and other fees. One set of empirical findings suggests that a $100 increase in tuition not offset by additional student aid is likely to result in enrollment declines varying from negligible to almost 2 percentage points, depending among other things on the family income of the student and the type of institution attended. 12/ Increases in family income, however, can offset the adverse effect of higher college charges. As shown in Table 4, family incomes and (to a greater extent) student aid have generally kept pace with college fees.

As indicated in the lower panel of Table 4, costs at both public and private institutions rose by roughly 75 percent during the period 1967-1976. The consumer price index (a measure of the general price level) rose by somewhat less--70.5 percent. As a result, real college costs (that is, costs adjusted for inflation) rose by only 2.2 percent at public institutions and 3.7 percent at private institutions.

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earning $10,000 or $20,000 five or ten years ago. Because such families have a smaller "real income" today, their enrollment rate is likely to be lower. In order to focus on enrollment changes for families with the same real income, therefore, family incomes must be adjusted for inflation.

12/ Gregory A. Jackson and George B. Weathersby, "Individual Demand for Higher Education: A Review and Analysis of Recent Empirical Studies," Journal of Higher Education, vol. 46 (November/ December 1975), pp. 623-52.

TABLE 4. COLLEGE COSTS, FAMILY INCOME, STUDENT AID, AND THE GENERAL PRICE LEVEL

Year	Students costs a/		Family Income b/			Federal Appropriations Per Student c/	Consumer Price Index d/
	Public	Private	Median	80th Percentile	Top 5 Percent		
	(Amounts in Dollars)						
1967	1,063	2,205	7,933	12,270	19,025	87	100.0
1968	1,117	2,321	8,632	13,400	20,590	92	104.2
1969	1,024	2,531	9,433	14,751	22,703	82	109.8
1970	1,288	2,739	9,867	15,531	24,250	97	116.3
1971	1,357	2,917	10,285	16,218	25,325	107	121.3
1972	1,458	3,038	11,116	17,760	27,836	165	125.3
1973	1,517	3,164	12,836	19,253	30,015	160	133.1
1974	1,617	3,386	12,902	20,690 e/	32,199 e/	210	147.7
1975	1,748	3,667	13,719	22,037 e/	34,144 e/	248	161.2
1976	1,854	3,896	14,958	23,923 e/	37,047 e/	315	170.5
	CUMULATIVE PERCENTAGE CHANGE FROM 1967						
1968	5.1	5.3	8.8	9.2	8.2	5.7	4.2
1969	13.3	14.9	18.9	20.3	19.3	-1.1	9.8
1970	27.2	24.2	24.4	26.6	27.5	11.5	16.3
1971	27.5	32.3	29.6	32.2	33.1	23.0	21.3
1972	37.2	37.8	40.1	44.7	46.3	89.7	25.3
1973	42.7	43.5	61.8	56.9	57.8	83.9	33.1
1974	52.1	53.6	62.6	68.6	69.2	141.4	47.7
1975	64.4	66.3	72.9	79.6	79.5	185.1	61.2
1876	74.2	76.7	88.6	95.0	94.7	262.1	70.5

a/ Includes charges for tuition fees, room, and board as found in U.S. Office of Education, National Center for Education Statistics, Projections of Education Statistics, table 41, p. 86. Costs for 1976 are NCES estimates (year 1967 equals academic year 1967-68, etc.)

b/ U.S. Bureau of the Census, Statistical Abstract of the U.S., 1976 and U.S. Bureau of the Census, Current Population Report, Series P-60, no. 105, table 10 (June 1977), p. 45, and table 13, p. 58, and no. 107 (September 1977), table 1, p. 6, and Table 4, p. 11.

c/ CBO estimates based on data from the following sources: U.S. Office of Education, Bureau of Higher Education, Factbook (1976); U.S. Office of Education, Office of Guaranteed Student Loans, Monthly Report (December 1976); and U.S. Office of Education, National Center for Education Statistics, Fall Enrollment in Higher Education (Selected Years).

d/ Economic Report of the President, January 1977, p. 241; and U.S. Department of Commerce, Survey of Current Business (November 1977), table S-8.

e/ Not strictly comparable to earlier years due to revised procedure.

This increase in college costs, however, has been offset by a rise in family incomes, both in real and current dollar terms. From 1967 to 1976 median family income increased by 88.6 percent (10.6 percent in real terms), compared to the increase in college charges of roughly 75 percent. 13/ Because of the relatively faster growth in family income, student costs at public institutions decreased from 13.4 percent to 12.4 percent of median family income, and student costs at private institutions fell from 27.8 percent of median family income to 26.1 percent during the 1967-1976 period.

Families with incomes well above the median have experienced an even faster growth in income. For those in the 80th percentile (that is, just below the richest 20 percent) and those in the top 5 percent, the growth in current dollar income has been about 95 percent. As a result, college costs for those families with incomes of approximately $25,000 or more in 1976 comprised a smaller portion of income than for comparable families in 1967.

Growth in federal student aid has also helped to offset increases in college costs for middle-income families. During the period 1967-1976, appropriations for the major student aid programs grew 262 percent per full-time-student equivalent. While most of the appropriations were for programs primarily aiding lower-income students, the Guaranteed Student Loan Program (GSLP)--the primary source of assistance for middle-income families also grew substantially. From 1967 to 1976 appropriations for the GSLP (which primarily represent the subsidy element of the program) rose by 433 percent on a full-time-student equivalent basis while the volume of loans increased by 121 percent on a full-time-student euivalent basis. 14/ During

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13/ Using a different measure, U.S. per capita disposable income increased 101 percent during the 1967-1976 period. See Economic Report of the President, January 1977, Tables B-22 and B-26, and U.S. Department of Commerce Survey of Current Business (October 1977) Table S-2.

14/ CBO estimates based on data from the following sources: U.S. Office of Education, Bureau of Higher Education, Factbook (1976); U.S. Office of Education, Office of Guaranteed Student Loans, Monthly Report (December 1976); and U.S. Office of Education, National Center for Education Statistics, Fall Enrollment in Higher Education (Selected Years).

21-200 O - 78 - 5

this period, students with adjusted family incomes of $15,000 or less (approximately $19,000 of adjusted gross income) were eligible for federal payment of interest charges on their loans while they were in school 15/ Thus, even for families not covered by the student aid programs focused on low- and moderate-income groups, federal support has risen faster than college costs.

These data on family income, college fees and student aid do not support the claim that the financial burden of college expenses has increased for middle- and upper middle-income families in general. Factors other than cost increases may be more important in explaining changes in enrollment patterns. Such factors may include reduced military manpower requirements, the declining rate of return from a college education, family preferences for consumer expenditures, and simply the decision of some to work rather than to study.

15/ In 1976, the ceiling for this subsidy was raised to $25,000 of adjusted family income (roughly $31,000 of adjusted gross income). The difference between these two income concepts is that adjusted family income reflects adjustments for personal tax exemptions and other deductions while adjusted gross income does not.

CHAPTER III. EDUCATION TAX ALLOWANCES

Adopting an education tax allowance is one way to provide financial relief to middle-income families for higher education costs if the Congress decides that additional federal funds should be spent for this purpose. An education tax allowance can take various forms, each of which would have different budgetary costs, distributional outcomes, and policy implications. The major forms of education tax allowances are discussed in this chapter. The legislative history of proposals for education tax allowances is then briefly reviewed to show how these various proposals have varied over time.

FORMS OF EDUCATION TAX ALLOWANCES

Education tax allowances can take three basic forms: a deduction against adjusted gross (or gross) income; a credit against tax liability; and a deferral (or postponement) of tax payments.

Tax Deductions

Tax deductions for education expenses provide benefits by reducing the taxable income base. Usually the designated base is adjusted gross income, although gross income may be chosen to extend the benefits to those who do not itemize. 1/ Because a deduction reduces the tax base to which progressive tax rates are applied, a deduction is worth more to high-income taxpayers than to those with low incomes. For example, a $100 deduction is worth $70 to someone with a top 70 percent marginal tax rate but only $30 to a taxpayer with a 30 percent marginal tax rate.

1/ Adjusted gross income is reached by subtracting from gross income all deductions which are not "itemized deductions" or personal exemptions. Taxable income is adjusted gross income minus the total of personal exemptions and either an amount now called the "zero bracket amount"--formerly called the standard deduction--or, if greater, itemized deductions.

Tax Credits

In contrast to a tax deduction which reduces the tax base, a tax credit reduces the taxpayer's liability directly and thus is worth more than a deduction of the same amount. For example, a $100 tax credit provides a tax benefit of $100 (unless the taxpayer does not have $100 of tax liability to be offset by the credit), 2/ while a $100 deduction provides a tax benefit ranging from $14 to $70. A tax credit provides the same tax reduction to those in high and low income brackets because, in contrast to a deduction, the tax saving does not depend on the taxpayer's marginal tax rate. 3/

Tax Deferrals

Tax deferrals for education expenses can be viewed as a form of higher education loan by which a taxpayer is granted relief in the form of postponement of part of his tax payments. The repayment of deferred taxes can be spread over several years and may begin after the student leaves school to provide greater relief while the student is attending school. Interest can be charged on the tax loan to reduce the cost to the Treasury, or the tax loan can be made interest-free to provide more of a subsidy.

Thus, if a deduction for education expenses were allowed as an offset to gross income for arriving at adjusted gross income, it would always filter through to reduce the tax base even for those who do not itemize. If, however, it were allowed only as an itemized deduction, it would not benefit those whose itemized deductions do not exceed the standard deduction or zero bracket amount.

2/ If a tax credit is made "refundable," those whose tax liability is less than the credit would receive a cash payment equal to the difference.

3/ If a tax credit is used to provide an explicit subsidy, however, and the amount of the credit itself is not subject to tax, the benefit of the subsidy will vary with the recipient's marginal tax rate. A $100 tax-free credit is worth $200 of taxable income to someone with a 50 percent tax rate rate but is worth only $125 to someone with a 20 percent tax

The value of a tax deferral depends on the length of the payback period and on the interest rate charged. Tax loans with long payback periods and low interest charges are worth more than those with short payback periods and high interet charges. The value also depends on the taxpayer's marginal tax rate and on what rate of return the taxpayer can earn on savings. Individuals who can earn high after-tax rates of return on their savings are apt to place a higher value on their tax loans than are those who would not forego as much interest income by spending their own funds for higher education.

FURTHER DESIGN CONSIDERATIONS OF EDUCATION TAX ALLOWANCES

Tax deductions, credits, and deferrals can be related in various ways to family income, education expenses, and other factors to achieve preferred distributional or budgetary objectives.

Relating Tax Allowances to Education Expenses

The design of an education tax allowance must specify the type and the amount of education expenses to be offset by the allowance. A major distinction is often made between expenses that are required for instruction and those associated with day-to-day living. For the most part, proponents of education tax allowances have restricted coverage of expenses to those associated with instruction--tuition, fees, books, supplies, and equipment. 4/ Items such as room and board generally have been excluded from coverage, perhaps because of budgetary cost considerations. This type of restriction avoids bias against those students who live at home for financial or other reasons. Most direct education subsidies, however, do not impose this restriction on qualified expenses. These programs avoid the bias noted above by "covering" at-home living costs.

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rate. Most federal direct grant subsidies to businesses are treated as taxable income, thereby avoiding this problem. See Stanley S. Surrey and others, Federal Income Taxation: Cases and Materials, 1 (Foundation Press, 1972), pp. 214-15.

4/ Some proposals would cover tuition charges only and would reduce qualified expenses by amounts received as scholarships, fellowships, and veterans' benefits.

The amount of qualified expense which is offset by an education tax allowance depends on the amount of the qualified expenses and the fraction of them which may be offset. An allowance can be designed to apply to expenses between, for example, $500 (a floor) and $2,000 (a ceiling). An allowance with a high floor on qualified expenses will direct relatively more aid to those attending high-priced private institutions. 5/ A low ceiling on qualified expenses will reduce federal revenue losses.

Allowances that offset less than 100 percent of qualified expenses may reduce the extent to which institutions would be able to capture the subsidy (by raising tuitions or by reducing their student financial aid) without losing some students who would have to bear a portion of the cost increase. 6/ The fraction of each dollar of qualified expenses that is offset by an allowance can be constant or can vary with the level of education expenses. For example, an allowance can offset 50 percent of all qualified expenses or may offset 75 percent of the first $500, 50 percent of the next $500, and 5 percent of expenses above $1,000.

Relating Tax Allowances to Income

A tax allowance can be related to the taxpayer's income in order to produce a desired distribution of benefits or to reduce total costs. For example, if considerations of budgetary costs and family need suggest that benefits should not be extended to high-income families, the allowance can be reduced by some percentage of income above a specified level. The allowance could be reduced, for example, by 2 cents for each dollar of adjusted gross income above $25,000. This would completely phase out a $400 tax credit at $45,000 of adjusted gross income. 7/ If a

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5/ For a discussion of this point, see Chapter IV.

6/ This point is discussed more fully in Chapter IV.

7/ If a family had two children in school at the same time, and if a $400 credit were allowed for each student, then the total ($800) credit would not be phased.out completely until $65,000 of adjusted gross income was reached, unless the phase-down was calculated on a per-student basis.

faster phaseout is desired, the rate of reduction could increase with income. In the above example, a $400 credit would completely phase out at $40,000 if benefits were reduced by 2 cents for each dollar of income between $25,000 and $35,000 and by 4 cents for each dollar of income above $35,000.

At the low end of the income scale are many families with little or no taxable income or tax liability. These families would not benefit from education allowances that operate through a reduction of income taxes. If a tax credit is used, however, full benefits can be extended to those with little or no tax liability by making the credit "refundable"--that is, providing a direct cash payment to recipients if the credit exceeds their tax liability. 8/ In principle, the same outcome can be achieved when the mechanism is a tax deferral. In this case, the Treasury would make loans to low-income taxpayers even though no taxes were due. In the case of a deduction where benefits vary with marginal tax rates, cash benefit payments to nontaxpayers could be based on the lowest marginal tax rate; that is, the payment could be equal to 14 percent of qualified expenses.

If benefits are to be focused on middle-income families only, an appropriate allowance is one which incorporates a phaseout of benefits for taxpayers located at the upper end of the target income group. For example, the allowance could be reduced by 2 percent of adjusted gross income above $25,000. Also a nonrefundable allowance would seem appropriate when there is no intent to extend benefits to those with little or no tax liability. (Those in this group are generally eligible for direct federal aid.)

Relating Tax Allowances to the Number of Children Attending School

Another factor that can be introduced in the formulation of an education tax allowance is the number of students a family has attending school at the same time. Although almost all proposals that have been made would grant equal tax allowances for each child, the instances of families with two or more children attending school simultaneously are frequently cited

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8/ The earned income credit is an example of a refundable tax credit. See Internal Revenue Code of 1954, Section 43.

as the ones in which financial hardships are likely to be the greatest. Such families constitute roughly 15 percent of the families with 18- to 24-year-olds attending school full time and about 1 percent of all families. 9/ Concentrating aid on those families could reduce the costs of any program substantially and/or permit larger benefits for multiple-student families.

BRIEF LEGISLATIVE HISTORY OF EDUCATION TAX ALLOWANCES

A brief review of the history of proposals for education tax allowances shows how the different approaches have evolved. 10/ In the 1950s most of the proposals for education tax allowances offered a tax deduction against adjusted gross income for some portion of college expenses or, in some cases, provided an additional personal exemption for each student. In the 1960s a credit against tax liability became the popular form of tax allowance proposals, perhaps because of the recognition that deductions favor those with high tax rates over those with low tax rates. During the period from 1967 to 1977, six proposals for education tax credits passed the Senate, but none was ever approved by the House of Representatives.

Senator Abraham Ribicoff (D.-Conn.) was the chief sponsor of the first Senate-approved education tax credit measure. 11/ His 1967 amendment would have provided taxpayers a nonrefundable credit for college expenses equal to 75 percent of the first $200, 25 percent of the next $300, and 10 percent of expenses between $500 and $1,500. This credit was to be reduced by 1

9/ U.S. Bureau of the Census, Current Population Reports, Series P-20, no. 303 (December 1976), p. 38.

10/ A fuller discussion of the legislative history of education tax allowances is presented in John K. McNulty, "Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Personal Costs of Higher Eduation," California Law Review, vol. 61 (January 1973), pp. 4-14.

11/ Congressional Record, vol. 113, 90:1 (1967) pp. S9665-76 (debate on Ribicoff amendment) and p. S9688 (Ribicoff amendment passed).

percent of the taxpayer's adjusted gross income above $25,000. The Ribicoff amendment was attached to H.R. 6950, a bill restoring the investment tax credit. The amendment, however, was deleted from the bill in conference with the House.

In 1969 the Senate again passed a Ribicoff-sponsored tax credit amendment. 12/ The provisions of this measure were similar to those which passed the Senate in 1967 except that high-income tapayers would have benefited somewhat less. It offered a nonrefundable tax credit equal to 100 percent of the first $200 of expenses, 25 percent of the next $300, and 5 percent of expenses between $500 and $1,500. The credit was to be reduced by 2 percent of adjusted gross income above $15,000. In the conference with the House, the 1969 Ribicoff amendment was dropped from H.R. 13270, the bill which became the Tax Reform Act of 1969.

In 1971 the Senate passed its third education tax credit amendment. 13/ The measure was introduced by Senator Ernest F. Hollings (D.-S.C.) and was identical to the 1967 Ribicoff proposal except that the Hollings amendment was the first Senate-passed education tax credit measure that provided a refundable credit. The Hollings tax credit amendment, however, was dropped in conference on H.R. 10947, the Revenue Act of 1971.

In 1976 Senator William V. Roth, Jr. (R.-Del.) sponsored an education tax credit amendment that would have provided a nonrefundable tax credit of up to $250 per student when fully phased in. 14/ Unlike the Ribicoff and Hollings amendments, the Roth credit was not limited to a percentage of expenses (although the credit could not exceed tuition expenses) and was not phased out for high-income taxpayers.

Initially the Roth amendment was attached to H.R. 10612, the Tax Reform Act of 1976, but the conference committee con-

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12/ Congressional Record, vol. 115, 91:1 (1969), pp. S37289-305.

13/ Congressional Record, vol. 117, 92:1 (1971), pp. S18606-12.

14/ Tax Reform Act of 1976, S. Rept. 938. 94 Cong. 2nd sess. (1976), pp. 33-35.

21-200 O - 78 - 6

sidered the revenue loss excessive and deleted the Roth amendment prior to final passage of the bill. Subsequently the Senate passed the Roth proposal as an amendment to H.R. 1386, a bill which would have allowed Smith College a tariff exemption on the purchase of a set of imported carillon bells. 15/ A unanimous consent request for a conference on the bill was objected to in the House, and the legislation died as the 94th Congress ended.

In 1977 the Senate again approved an education tax credit, which was offered by Senator Roth as an amendment to S. 9346, the Social Security Financing Amendments of 1977. 16/ The amendment would have provide a $250 tax credit for students. In contrast to Senator Roth's previous proposals, however, a floor amendment was added to make the credit refundable during its first year so that direct payments would be made to those whose tax liability was less than the credit. The Roth amendment was dropped from the social security bill in the House-Senate conference.

In 1977 the House Budget Committee's Task Force on Tax Expenditures, Government Organization, and Regulation held hearings on the subject of college tuition tax credits. 17/ Later in the year, during debate on the Second Concurrent Resolution on the Budget for Fiscal Year 1978, proponents of education tax allowances successfully managed to provide $175 million in the budget for possible passage of an education tax allowance. 18/

15/ Congressional Record, vol. 122, 94:2 (1976), pp. S16002-5.

16/ Congressional Record, daily ed., November 4, 1977, pp. S18792-802.

17/ See Report on Hearings before the Task Force on Tax Expenditures, Government Organization, and Regulation on College Tuition Tax Credits, House Committee on the Budget, 95 Cong. 1 sess. (Committee Print 95-12, November 1977).

18/ Congressional Record, daily ed., September 8, 1977, pp. H9028-30 and September 9, 1977, pp. S14510-16.

Also the Senate Finance Committee scheduled three days of hearings on the issue of education tax allowances in January 1978. 19/

19/ "Finance Subcommittee on Taxation and Debt Management Sets Hearings on Tuition Tax Relief Bills," Press Release, U.S. Senate Committee on Finance, Subcommittee on Taxation and Debt Management Generally, December 19, 1977.

CHAPTER IV CRITERIA FOR COMPARING ALTERNATIVE SUBSIDY PROGRAMS

If the Congress considers additional student aid for middle-income families, it may want to compare tax subsidies and nontax alternative forms of aid. This chapter discusses one set of criteria for making that comparison. In the next chapter these criteria are applied to various tax subsidies and other forms of student aid. 1/

COST

An important factor in evaluating any government subsidy program is its cost to the Treasury. More costly progams result in larger deficits or, alternatively, require additional tax revenue to be raised 2/ or require reductions to be made in other types of government spending. More costly programs also leave relatively less room to introduce other new spending programs or to enact tax reforms that cut taxes.

Cost estimates for alternative subsidy programs are given in the next chapter. It should be noted, however, that in general tax deferrals and other types of loans are, by their nature, less costly in the long run than are tax credits, deductions, or other types of grants of the same magnitude. 3/ Loans assist families

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1/ The criteria developed here do not exhaust all possibilities, but they do provide a basis for budgetary decision-making. Different readers may find some of the criteria more important than others and thus can place more weight on them when deciding among alternatives.

2/ If taxes are raised to finance an education subsidy program for middle-income families, those receiving the subsidy may find that they must pay higher taxes for a long time in exchange for relatively short-term relief.

3/ If the government's discount rate were equal to the interest rate charged on loans, the present value of the government's cost for loan programs would be zero (except for administrative and default costs).

by providing them with liquidity and allowing them to spread their financial burdens over an extended period of time. Grants, in contrast, provide relief with no payback requirement. 4/ Grant and loan programs having the same long-term budget cost will, therefore, differ in the amount of short-term relief provided. Loans can provide greater short-term relief than grants having the same long-term cost since loans are repaid.

The cost of a particular loan or grant program will depend on its characteristics. By changing subsidy amounts and eligibility restrictions, program costs can be set at whatever level desired. This point will be illustrated by considering cost-reducing variations in some of the programs described in Chapter V.

DISTRIBUTIONAL EFFICIENCY

A government subsidy program is efficient when it serves the intended purpose at minimum cost. Alternatively, an efficient subsidy is one which provides maximum desired benefits for a given cost. As indicated in Chapter II, the main objective of most proposals for education tax allowances apparently is to distribute additional educational aid to students from middle-income families. Thus, in measuring the distributional efficiency of alternative student aid programs in the next chapter, attention will be given to the portion of total benefits that accrues to middle-income students rather than to those in other income groups. Although the definition of "middle-income families" is not rigid, a review of recent Congressional proposals for education tax allowances suggests that the $10,000 to $25,000 income group is a reasonable approximation of the target group of many proposals.

This narrowly defined measure of efficiency ignores the question of whether additional federal funds should be spent for higher education subsidies and, if so, whether the benefits should be focused on middle-income families. It also does not measure the efficiency of these subsidies in meeting other possible education policy goals, such as increasing higher education opportunities for those who could not otherwise attend college.

4/ Under tax deferrals or other types of loan programs, the recipient is the one who bears the burden of repayment. Under tax credits, deductions, or other grant-like programs, the general public bears the burden of payments.

Nevertheless, it is an important criterion when one is simply concerned with deciding on an appropriate way to assist middle-income students.

The distributional efficiency of a student subsidy for education expenses is reduced to the extent that institutions capture the benefits either by raising fees or by altering their financial aid policies. When the subsidy is generally available to most students and can be used to offset costs on a dollar-for-dollar basis, institutions could raise student fees without losing many students since most students would not experience a net increase in college costs. Even when the subsidy is focused on a narrowly defined group of students or when less than a dollar of costs can be offset by each dollar of subsidy, institutions nevertheless could capture the subsidy without losing students by simultaneously raising fees and providing additional aid to selected students. Finally, in those cases in which students who are receiving financial aid from an institution also qualify for the subsidy, the institution could capture the subsidy by reducing its financial aid to those students.

Although these strategies would capture the student subsidy, it is not clear whether schools or state legislatures that often mandate fees at public institutions would fully exploit the opportunity. Certainly institutions have significant pressures to raise fees since the costs of supplying education services have increased substantially in recent years. In addition, with the last of the postwar baby boom generation now largely through college, this source of enrollment growth can no longer be counted upon to defray rising institutional costs. At the same time, those institutions faced with declining enrollments may want to obtain an advantage in the competition for students. They therefore might not raise student fees or reduce their financial aid to students even though other institutions were doing so in response to student subsidies.

FAIRNESS AND EQUITY

Issues of fairness and equity are also appropriate considerations when evaluating alternative education subsidy programs. People may differ in their judgment as to what constitutes a fair distribution of subsidy payments (whether or not the payments are distributed through the tax system). In general, however, most people probably believe that subsidies should be distributed

either (a) equally among all recipients regardless of income or (b) progressively, with those with more income receiving smaller subsidies than those with less income.

For example, the distribution of welfare payments may be considered equitable because the benefits are based on financial need--those with less income but similar in other respects get larger benefit checks than those with more income. In contrast, G.I. Bill education benefits and the insulation tax credit proposed in President Carter's energy program provide benefits without regard to income. Although G.I. Bill education benefits vary depending on whether the veteran attends school on a full-time or part-time basis and on the number of dependents the veteran is supporting, those veterans in similar circumstances in these respects receive the same amount of monthly benefits regardless of their other income. The insulation tax credit would be varied in accordance with insulation costs to the taxpayer, not with respect to his income. 5/

When subsidies are distributed through the tax system, they may also be judged also on the basis of how they affect equity among taxpayers who are similarly situated (horizontal equity) and among taxpayers with different incomes (vertical equity). This issue, however, has not played an important role in shaping most education tax allowance proposals, and tax policy has not been used as a criterion for evaluating education tax subsidies in the next chapter. Appendix B provides a discussion of tax equity, including consideration of when tax subsides for education may be appropriate and how such subsidies may be evaluated in terms of tax equity.

MAINTAINING INSTITUTIONAL DIVERSITY

A relevant criterion for evaluating alternative student aid progrms is whether they are likely to have a neutral or nonneutral effect on the competitive balance between private (independent)

5/ Strictly speaking, the benefits of an insulation tax credit would be distributed equally regardless of income only if the credit is refundable. The Administration-proposed insulation tax credit is not refundable.

and public institutions. 6/ Although its effect is difficult to forecast, a subsidy could affect the proportion of students at public and private institutions in two ways.

First, a subsidy to students will lower the net price of higher education--assuming that institutions do not capture it through higher fees or other policies. 7/ Little can be said with confidence, though, about the net change in enrollments at public and private institutions resulting from a general lowering of the price of higher education.

Second, changes in the cost difference between public and private institutions brought about by the subsidy can be measured either in absolute or relative terms. If it costs $4,000 to attend a private college and $2,000 to attend a public institution, the absolute cost difference is $2,000; in relative terms, the private school costs twice as much. A $1,000 student subsidy would reduce the net price of attending these schools to $3,000 and $1,000, respectively. Although this subsidy would not change the absolute cost difference, it would raise the relative price of attending the private institution to three times the price of attending the public institution ($3,000/$1,000 = 3). This increase in the relative price of the private institution may induce some students to attend the public institution whose relative price has fallen.

6/ Congressman Barber Conable, Jr. (R.-N.Y.), for example, has expressed concern about the financial viability of private institutions. See Tuition Tax Credits, Hearings before the House Budget Committee's Task Force on Tax Expenditures, Government Organization and Regulation, 95:1 (1977), pp. 19-25. In their recent study, Bowen and Minter conclude that private institutions are holding their own relative to public institutions. See W. John Minter and Howard R Bowen, Private Higher Education: Third Annual Report on Financial and Educational Trends in the Private Sector of American Higher Education (Association of American Colleges), 1977, p. 61.

7/ When institutions raise tuitions or reduce student aid, they benefit at the expense of students. If institutions do not change their tuition or financial aid policies, students retain the subsidy and institutions may benefit from increased enrollments.

On the other hand, if the subsidy is a percentage of cost, the relative costs would remain the same as they were before the subsidy, but the absolute cost difference would change. If, in the above example, a subsidy were provided for 25 percent of education expenses, the net cost of attending the private school would fall to $3,000 while the net cost of the public school would decline to $1,500. The relative price difference is unchanged (the private school still costs twice as much as the public), but the absolute cost difference is reduced from $2,000 to $1,500. In general, subsidies which reduce the absolute cost difference (the "tuition gap") are likely to favor institutions with higher costs.

In short, flat amount subsidies increase the relative cost difference and tend to favor public institutions while percentage-of-cost subsidies reduce the absolute cost difference and tend to favor private institutions. The next chapter will analyze student subsidies in terms of their impact on the absolute and relative price difference of these institutions.

EASE OF ADMINISTRATION

A desirable feature of an education subsidy program is ease of administration. An easily administered program will generally involve fewer administrative costs and shorter delays in the distribution of benefits

A number of factors bear on the ease of administration. If eligibility must be certified before payment of benefits, an agency must make the determination. Generally, direct spending programs have required such agency certification. In contrast, tax programs give benefits to anyone who claims them; "certification" is achieved subsequently by auditing a small percentage of claims.

Programs that impose several restrictions on the eligibility of applicants and on the type of benefits claimed will require more diligent monitoring of the distribution of benefits. This monitoring will generally be more difficult to perform when the agency responsible for administering the program is not the agency most familiar with making the type of evaluations required by the restrictions of the program.

The tax system may be as efficient as other mechanisms for distributing subsidy payments when the subsidies are generally

available to most taxpayers, when certification of eligibility is not required, and when unfamiliar or unusual evaluations by the Internal Revenue Service are not necessary. Under these conditions, administration of the program may be similar to such routine functions as the distribution of refund checks. When the subsidy does not have these features, however, the tax system loses its ability to operate as an easily administered distribution mechanism.

The alternative subsidies discussed in the next chapter will be evaluated in light of their potential for administrative complexity. Where possible, differences in administrative difficulties will be indicated.

BUDGET VISIBILITY AND CONTROLLABILITY

The final standard that will be used to compare alternative student aid subsidies is how visible and controllable a program is in the federal budgetary process. Programs that are more visible than others are more likely to be subject to annual review and thus have a greater potential for better control.

Despite a growing recognition and understanding of tax expenditures, they are not highly visible in the federal budget process, 8/ and no procedure for regular review of tax subsidies has been developed. Unlike most direct spending programs, tax expenditures are entitlements, which generally do not require annual budget authorization and appropriations and thus are not

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8/ The first tax expenditure budget was published in 1968. See U.S. Department of the Treasury, Annual Report of the Secretary of the Treasury for Fiscal Year 1968, pp. 326-40. The Congressional Budget Act of 1974, P.L. 93-344 (July 12, 1974) requires that the President's budget include a list of tax expenditures (Sec. 601). The most recent tax expenditure budget presented by the Administration appears in Special Analyses, Budget of the U.S. Government, Fiscal Year 1978, pp. 128-30, Table F-1. The House and Senate Budget Committees also present tax expenditure estimates. See, First Concurrent Resolution on the Budget for Fiscal Year 1978, H. Rept. 189, 95:1 (1977), pp. 109-20 and First Concurrent Resolution on the Budget for Fiscal Year 1978, S. Rept. 90, 95:1 (1977), pp. 19-25.

subject to the discipline of the budgetary process imposed on most other programs.

Advocates of student aid subsidies may not desire high budgetary visibility and controllability--these features might increase the likelihood that the subsidy will compete with other education programs for Congressional support and limited federal funds. This group therefore would probably prefer tax allowances (which also may be attractive because some people may believe that tax subsidies really do not involve the spending of federal funds). On the other hand, those who would not benefit from education tax allowances and those whose main concern is maintaining control over the budget may prefer direct grants or other subsidy forms that are relatively more visible and controllable than tax allowances.

CHAPTER V. ALTERNATIVE PROGRAMS OF AID FOR MIDDLE-INCOME STUDENTS

This chapter analyzes five alternative mechanisms for distributing additional federal aid to students or their families, especially those in middle-income classes. 1/ These mechanisms include tax and nontax programs in the form of both grants and loans. (A tabular overview of this analysis is provided in the Summary.)

TAX CREDIT OR CREDIT/DEDUCTION OPTIONS

Several different types of benefit formulas and eligibility criteria can be combined to produce alternative tax credit and credit/deduction plans for the expenses of higher education. One option would be simply to provide a nonrefundable $250 tax credit for every student, applicable to expenses for tuition, fees, books, supplies, and equipment. 2/ Another possibility would be to grant an option to choose between a nonrefundable $200 tax credit or a $1,000 deduction. Each of these two plans could be modified to reduce revenue losses and/or focus benefits more precisely on middle-income families. The specific modifications considered here are (1) reducing the size of each tax credit by 1 percent and the size of each deduction by 5 percent of adjusted gross income above $25,000 and (2) limiting the size of

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1/ As indicated earlier, the analysis does not address the fundamental issues of whether additional federal funds should be spent for higher education and, if so, whether education policy is best served by focusing the aid on students in the middle-income group.

2/ For this and other tax options considered in this chapter, it is assumed that the subsidy will be prorated for part-time students. Eligible students are defined to include taxpayers, spouses, or dependents who maintain at least half of a full-time course load at postsecondary institutions of higher education or vocational schools.

the allowance for one-student families to one-half the amount that can be taken for second and subsequent students in a family with two or more students enrolled in school simultaneously.

Cost and Distributional Efficiency

Table 5 shows that slightly less than half (49.4 percent) of the tax savings from a nonrefundable $250 credit costing about $1.7 billion would go to taxpayers with incomes between $10,000 and $25,000, and 37.3 percent would go to families whose incomes exceed $25,000. Table 6 shows that, under a nonrefundable $200-tax-credit/$1,000-deduction option costing about $1.9 billion, middle-income families would receive a smaller proportion (41.7 percent) than under the $250 credit plan, but those having at least $25,000 of income would receive more--48.2 percent. This shift in the proportion of benefits from low- and middle-income families to upper-income families occurs because tax deductions are worth more than tax credits to those in higher income tax brackets and are worth less than credits to those in lower tax rate brackets.

If a general $250-per-student tax credit were reduced by 1 percent of the taxpayer's adjusted gross income above $25,000, the cost of the program would be lowered to $1.4 billion. Middle-income families would get 59.6 percent. No taxpayer earning more than $50,000 would benefit. 3/

The cost of a nonrefundable $200-tax-credit/$1,000-deduction program of the same sort but with the credit phased down by 1 percent and the deduction phased down by 5 percent for each dollar of adjusted gross income above $25,000 would be $1.3 billion. Those earning between $10,000 and $25,000 would get 58.4 percent of the tax savings. Families earning more than $45,000 would not benefit from this option.

Instead of phasing down the allowances for incomes above $25,000, the size of the credit or deduction could be reduced

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3/ A family earning more than $50,000 would benefit from a credit if the credit were not phased out on a per-student basis and if the family had more than one member in school at the same time. See Chapter III, footnote 7.

TABLE 5. SIZE AND DISTRIBUTION OF BENEFITS UNDER A NONREFUNDABLE TAX CREDIT OF $250 COSTING APPROXIMATELY $1.7 BILLION IN FISCAL YEAR 1978 a/

	Adjusted Gross Income Class (Dollars in Thousands)			
	0-10	10-25	25+	All Groups
Aggregate Benefits (Dollars in Millions)	223	831	628	1,682
Percentage of Total Benefits	13.3	49.4	37.3	100
Average Benefit Per Eligible Student (Dollars) b/	143	160	213	174

a/ CBO estimate based on data from the U.S. Bureau of the Census; data from the U.S. Office of Education, National Center for Education Statistics; data supplied by Joseph Froomkin, Inc.; and tax data published by the U.S. Department of the Treasury, Internal Revenue Service.

b/ The average benefit for students with family incomes above $25,000 is greater than that for students in the $10,000-$25,000 income class because those in the higher income group are more likely to attend school on a full-time basis. The average benefit for full-time students in both of these income classes would be $250. Many full-time students with family incomes below $10,000 would not get the full credit because the family's tax liability is less than $250.

TABLE 6. SIZE AND DISTRIBUTION OF BENEFITS UNDER A $200-CREDIT/ $1,000-DEDUCTION OPTION COSTING APPROXIMATELY $1.9 BILLION BILLION IN FISCAL YEAR 1978 a/

	Adjusted Gross Income Class (Dollars in Thousands)			
	0-10	10-25	25+	All Groups
Aggregate Benefits (Dollars in Millions)	188	777	899	1,864
Percentage of Total Benefits	10.1	41.7	48.2	100
Average Benefit Per Eligible Student (Dollars)	120	150	305	192

a/ CBO estimate based on data from the U.S. Bureau of the Census; data from the U.S. Office of Education, National Center for Education Statistics; data supplied by Joseph Froomkin, Inc.; and tax data published by the U.S. Department of the Treasury, Internal Revenue Service.

by half for the first student a family has enrolled in school, with the higher level retained for second and subsequent students enrolled in school at the same time. This would reduce the total cost of the plan substantially since only about one family out of seven with students in school has more than one student in school at the same time. 4/ (To take care of families who have students attending school back-to-back rather than simultaneously, eligibility for the higher subsequent-student benefit might be extended for a period of time after the first student graduates.)

This restriction on benefits would lower the total cost of the tax credit plan to $1.1 billion. It would also change the distribution of benefits somewhat. Families earning between $10,000 and $25,000 would get a slightly smaller share (47.2 percent) than under the unrestricted credit plan, and those earning more than $25,000 would get a slightly larger share (40.8 percent). This change in distribution occurs because high-income families are more likely to have more than one student in school at the same time. 5/

If the tax credit/deduction option were modified in the same way, the total cost of the plan would be lowered to $1.2 billion, with 39.1 percent going to middle-income families and 52.0 percent to upper-income families.

Fairness and Equity

The tax credit option is more appropriate than the credit/deduction option for those who believe that subsidies should not

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4/ U.S. Bureau of the Census, Survey of Income and Education (Spring 1976).

5/ Ibid. If this form of tax allowance were adopted, low-income families who currently cannot afford to send more than one student to school at the same time might become able to do so. To the extent that such behavior is induced by the allowance, low-income families would get somewhat more than 12.0 percent of the benefits.

be larger for those with higher incomes. 6/ If, because of income distribution considerations, one prefers a more progressive distribution of subsidies than that provided by a simple tax credit, then the tax credit that is phased down for families with adjusted gross incomes above $25,000 is more appropriate than the one which is not. Reducing the size of the allowance for a family's first student produces a less progressive distribution of benefits than that realized under the simple tax credit since those in higher income groups are more likely to have more than one student in school at the same time.

Maintaining Institutional Diversity

The tax credit and credit/deduction options presented above may have an adverse impact on the competitive position of the more expensive private schools because they do not reduce the absolute cost difference of attending these schools but do raise the relative price of attending private institutions (see Chapter IV). The reason is that they provide fixed dollar benefits rather than benefits determined as a percentage of qualified expenses. 7/

The modified plans that reduce the size of the tax allowance for the family's first student or phase down the allowance for

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6/ As indicated in footnote b/ of Table 5, the $250 tax credit plan would provide the same average benefit ($250) for full-time students in both the middle- and upper-income groups. Many full-time students with family incomes below $10,000, however, would not get the full $250 credit because the family's tax liability is too low and the credit is not refundable.

7/ As indicated in Chapter IV, an example of an allowance that would reduce the absolute cost difference between high- and low-cost schools but would not change the relative price difference is a tax credit (or credit/deduction option) equal to 25 percent of qualified expenses. An allowance which would generally reduce the relative cost of attending a high-cost institution is one which applies only to expenses above some level, say $500.

those earning more than $25,000 would have less of an impact on the competitive balance between public and private schools simply because, with many students eligible only for reduced allowances, fewer students would experience as much change in relative prices.

Ease of Administration

The ease of administering an education tax credit or credit/deduction program depends mainly on the extent to which restrictions are imposed. Therefore, the relatively unrestricted tax credit and credit/deduction plans presented above rank somewhat higher in terms of administrative ease than do the modified plans that depend on the family's income or on the number of students a family has in school. The difference, however, is probably not great. The effective monitoring of any of these tax allowances, of course, would require the IRS to verify that students for whom allowances have been claimed are in fact attending school on at least a half-time basis.

Budget Visibility and Controllability

Even with the annual reporting of tax expenditures, an education tax credit or credit/deduction plan would rank low in terms of budgetary visibility and controllability. The tax expenditure concept is still relatively new, and tax subsidies in general tend not to receive as much review and scrutiny as direct subsidies. More importantly, however, an education tax allowance is an entitlement program that provides benefits for all students who qualify. Once subsidy amounts and eligibility requirements have been established, program costs cannot be controlled because they are not subject to fixed appropriation ceilings.

BASIC EDUCATIONAL OPPORTUNITY GRANTS

Another way to provide more student aid for the middle-income group would be to expand the Basic Educational Opportunity Grants (BEOG) program that is currently designed to assist low- and moderate-income students. 8/ One option would be to increase the

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8/ Other needs-tested student assistance--such as Supplemental Educational Opportunity Grants and the Work/Study Program--also

size of the maximum award to $2,100, 9/ and to reduce from 30 percent to 20 percent the share of "discretionary income" above $5,000 that a family is expected to contribute toward the financing of higher education costs. 10/ Although these program changes would increase the amount of aid going to those already receiving BEOGs, the changes would also extend benefits to 490,000 middle-income students who now do not qualify because their family income is too high.

Cost and Distributional Efficiency

Table 7 shows that the above-described changes in the BEOG program would cost $812 million. Approximately 72 percent of these additional funds would go to families earning between $10,000 and $25,000, while families earning more than $25,000 would receive an insignificant share. This option ranks higher, in terms of distributional efficiency, than the tax allowances discussed earlier since middle-income students would get a larger share of total additional benefits. 11/ It should be noted, however, that fewer students (including those from middle-income families) would benefit from these changes in the BEOG program than from the

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could be changed to include a greater number of middle-income students. A broad approach of this sort might give a more complete coverage to needy middle-income students.

9/ The Education Amendments of 1976 raised the ceiling on the maximum award from $1,400 to $1,800. Fiscal year 1978 appropriations for the BEOG program, however, will effectively limit the maximum award to $1,600 for this year.

10/ Discretionary income is basically adjusted gross income plus transfer payments minus both federal taxes and the amount of income needed to sustain a family at the poverty level.

11/ A change in the BEOG program that lowers to 20 percent the expected contribution rate on discretionary income but does not raise the BEOG ceiling would cost $155 million. Approximately 87 percent of these additional funds would go to middle-income students. In contrast, a change that raises the BEOG ceiling from $1,600 to $2,100 but that does not lower the contribution rate would cost $698 million, of which only 65 percent would go to middle-income students.

TABLE 7. DISTRIBUTION OF ADDITIONAL BENEFITS FROM RAISING THE MAXIMUM BEOG AWARD TO $2,100 AND LOWERING THE FAMILY CONTRIBUTION RATE FROM 30 TO 20 PERCENT ON DISCRETIONARY INCOME ABOVE $5,000 a/

	Adjusted Gross Income Class (Dollars in Thousands)			
	0-10	10-25	25+	All Groups
Distribution of Additional Benefits (Dollars in Millions)	224	588	--	812
Percentage of Additional Benefits	27.6	72.4	--	100
Average Additional Benefit Per Recipient (Dollars) b/	163	383	--	279

a/ CBO estimates based on simulations with the U.S. Office of Education's BEOGs estimation model, updated December 1977.

b/ To estimate how the incremental $812 million would be distributed among recipients on average, it was assumed that the average award for new beneficiaries would be the same as the increase in award size for those already in the program.

tax allowances discussed above since the eligibility limitations in the BEOG program are more restrictive. 12/ The tax allowances would provide benefits to all students attending college on at least a half-time basis. In contrast, the BEOG program restricts benefits to students who can demonstrate financial need on the basis of college costs and expected family contribution.

The average additional award associated with these changes in the BEOG program would be larger for those in the middle-income class than for those with low family incomes, although low-income students would continue to receive larger overall awards than those going to middle-income students. 13/ Two reasons account for this outcome. First, very few students with family income below $10,000 will benefit from the reduced contribution rate on discretionary income above $5,000 since the discretionary income of most families in this group is less than $5,000. Second, many low-income students now eligible for BEOGs attend relatively low-cost schools and would not benefit fully from an increase in the maximum award from $1,600 to $2,100 because of a program restriction that limits the award to one-half the cost of college attendance.

Middle-income students would benefit from both program changes to a much greater extent. More of these students would benefit fully from the maximum award increase to $2,100 because their attendance at high-cost institutions makes the half-cost of attendance limitation on BEOG awards less likely to be binding. Middle-income students also would benefit more than low-income students from the reduction from 30 to 20 percent in the fraction of discretionary income above $5,000 that a family is expected to contribute.

Fairness and Equity

These changes in the maximum BEOG award and the expected family contribution would not result in a uniform distribution of

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12/ Eligibility requirements of the BEOG program are outlined in Appendix A.

13/ Under a BEOG program with a $2,100 maximum award and a 20 percent family contribution rate on income above $5,000, the average awards would be $1,135 for those with incomes below

additional funds among recipients. Students in the middle-income group would get relatively larger additional average benefits than those in the low-income group. In this respect, the distribution of benefits resembles that resulting from the tax allowances discussed earlier. 14/ If a somewhat more equal distribution of subsidies than that resulting from these BEOG program changes is considered more equitable, the share of discretionary income above $5,000 that a family is expected to contribute could be left unchanged at 30 percent when the maximum BEOG award is raised to $2,100.

Maintaining Institutional Diversity

For all students whose BEOG awards would not be limited by the half-cost-of-attendance restriction, the program changes would provide the same amount of funds regardless of the type of school attended and thus would raise the relative cost of attending a high-cost institution, although the absolute cost difference would remain unchanged. For students whose awards are restricted by the half-cost-of-attendance limitation, the program changes generally would lower the absolute cost difference of attending a high-priced private institution. In this case, the relative price of attending a private institution could go up or down, depending on how much the half-cost-of-attendance limitation restricted the size of grants for those attending public institutions.

Ease of Administration

An expansion of the BEOG program of the sort described here could be accommodated by the existing system without substantially changing the nature of program operations. This mode of distributing more student aid to middle-income families necessarily would share the administrative problems associated with the current BEOG

$10,000 and $784 for those with incomes between $10,000 and $25,000.

14/ As indicated in footnote b/ of Table 5, full-time students in the middle-income group would receive an average benefit of $250 under the tax credit plan. Many full-time students with family incomes below $10,000, however, would not qualify for the full credit because the family's tax liability is less than $250 and the tax credit is not refundable.

program, including the detection of fraud and other abuses. 15/ It would involve a greater administrative burden than the tax allowances discussed above since more benefit claims are verified under the BEOG program than under the tax system, where only a very small percentage of returns is audited.

Budget Visibility and Controllability

Changes in the BEOG program would rank high in terms of visibility and controllability. Since the BEOG program is a direct spending program, its authorizations, appropriations, and outlays are reviewed annually in the course of the budget process. According to the BEOG legislation, the annual cost of the program can be kept within appropriation limits by reducing the average award size. In practice, however, when total grants have exceeded appropriations, the policy generally adopted has been to request supplemental appropriations rather than to reduce subsidy amounts. This course of action has resulted in less hardship for students and institution administrators.

STUDENT LOANS

If the Congress decides that loans rather than grants should be used to provide more assistance to students from middle-income

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15/ The extent of fraud and other abuses in the BEOG program is not known. A study conducted for the Office of Education concludes that "the degree of income misreporting [fraud] is small and the impact of misreporting is minor." Applied Management Sciences for the U.S. Office of Education, Validation of Student and Parent Report Data on the Basic Grant Application Form, vol. 6 (November 23, 1976), p. 6,. Other abuses in the program include students' enrolling in college, receiving basic grants, then dropping out of college. See Karen J. Winkler,"How Much Fraud in Basic Grants for Students," Chronicle of Higher Education (April 4, 1977), p. 11. Program administrators indicate that when fraud and abuses have been discovered in the BEOG program, steps have been taken to curb them (telephone conversation with Peter K. Voigt, formet Director of the BEOG program, January 4, 1978).

families, an expansion of the current federal loan programs might be considered. Direct federal loans are now made through the National Direct Student Loan Program (NDSLP); most nonfederal loans are guaranteed under the Guaranteed Student Loan Program (GSLP), which was established in 1965 specifically to aid middle-income families who face liquidity problems. If it is considered desirable to minimize the structural changes in the existing loan programs, then the GSLP is probably better suited to direct additional assistance to middle-income and upper middle-income students. Because of its needs test, the NDSLP focuses relatively more assistance on low-income families than does the GSLP, which has no strict needs test. 16/

The Education Amendments of 1976 made more middle-income and upper middle-income families eligible for GSLP benefits by raising from $15,000 to $25,000 the ceiling on adjusted family incomes that qualify a student for federal payment of interest charges while the student is in school. 17/ Also the total amount of loans a student can borrow for undergraduate training was increased from $7,500 to $10,000, while the total available for undergraduate and graduate training combined was raised from $10,000 to $15,000. 18/ These changes will not only provide an "in-school" interest subsidy to more middle-income families and allow each student to borrow more but are also expected to result in a greater number of loans made to this group.

Theoretically, any student can obtain a 7 percent loan under the GSLP even if the student's family income makes the student ineligible for the in-school interest subsidy. In practice, however, only about 4 percent of all loans have gone to such

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16/ Under the GSLP, however, an applicant is required to verify that the funds will be used to finance education expenses.

17/ Justification of Appropriations Estimates for Committee on Appropriations, Fiscal Year 1978, revised vol. 2, p. 185. An adjusted family income of $25,000 corresponds to an adjusted gross income of approximately $31,000. The higher-income ceiling will extend eligibility for GSLP benefits to about 85 percent of all students (CBO estimate).

18/ Justification of Appropriations Estimates, p. 185.

students. 19/ The apparent reason is that banks refrain from making many loans to students who do not qualify for the in-school interest subsidy because it is more costly and difficult to obtain interest payments from many individual students while they are in school than it is to collect interest payments from one source--the government. If this is the case, extending the in-school interest subsidy to those with family incomes ranging from $15,000 to $25,000 should result in more student loans going to these families.

The benefits to middle-income and upper middle-income families resulting from the 1976 amendments probably could be enhanced most by encouraging banks to increase the amount of guaranteed student loans (GSLs) in their loan portfolios. 20/ A scarcity of GSLs is now a major shortcoming of the GSLP. More GSLs might be provided by lenders if their net rate of return on GSLs were increased.

In addition to the 7 percent rate now charged on GSLs, lenders receive a "special allowance" from the government when market interest rates are high. The special allowance (2 7/8 percent for the fourth quarter of 1977) 21/ is related to the rate on three-month Treasury securities and can be as large as 5 percent. The net rate of return on GSLs, however, is reduced by the high cost of complying with administrative procedures.

19/ U.S. Office of Education, Analysis of Student Borrower and Loan Characteristics: Guaranteed Student Loan Programs, Draft (January 1974).

20/ Somewhat higher benefits for middle-income students could also be realized through federal payment of some of the interest costs now borne by students and by further raising (or eliminating) the limit on the amount of funds that a student can borrow. For those who believe that student aid should be extended to families with adjusted gross incomes above $31,000, raising the ceiling on the amount of family income that qualifies a student for the in-school interest subsidy might be an attractive alternative.

21/ Source: U.S. Office of Education.

The net rate of return to banks could be improved by increasing the rate charged to students (although this would reduce the student's subsidy), by raising the special allowance, or by reducing the bank's administrative costs. Increases in the basic rate and the special allowance have been considered by the Congress. The Office of Education has implemented some procedures to reduce administrative costs, such as centralization and automation of recordkeeping and report filing. Greater efforts in these areas might induce banks to provide more student loans.

Cost and Distributional Efficiency

Fiscal year 1977 federal outlays for interest and default payments on GSLs amounted to $447.6 million. 22/ The volume of loans made in fiscal year 1977 was $1.47 billion. Since data on the effect of the 1976 amendments on the volume and distribution of GSLs among income groups is not available, quantitative statements cannot be made about the benefits accruing to middle-income families. Banks have wide discretion in determining the volume of loans they will provide and to whom the loans will be made. Quantitative estimates of their response (and that of student borrowers) would necessarily involve arbitrary assumptions.

As noted above, though, it seems reasonable to expect that middle-income and upper middle-income students will receive a substantially larger portion of GSLs than before. This outcome would result from the extension of subsidy eligibility to these families and from a tendency for banks to favor students in the middle-income group if such students are thought to have a lower default rate than those in low-income groups. The effect of these two factors on the amount of aid going to middle-income families would be magnified if the willingness of lenders to provide a larger volume of GSLs were increased.

Fairness and Equity

Since all qualified students are potentially eligible for loans of the same size and at the same interest rate, this GSLP

22/ Of the total, $305 million was spent for interest payments, and $142.6 million was spent on default payments. Source:

option would be considered equitable by those who maintain that education subsidies should be distributed equally among all recipients. For those who believe that a progressive distribution of benefits is more equitable, a loan program which charges lower interest rates to those with less income might be preferred. (The NDSLP currently extends loans to low- and moderate-income students at an interest rate of 3 percent.)

Maintaining Institutional Diversity

Guaranteed student loans make available the same maximum amount of funds to students attending private and public institutions although the amount borrowed will generally depend on the amount of expenses incurred. Students who do borrow the maximum amount in either case will not experience an absolute dollar change in the current cost difference between high- and low-priced schools, but the relative out-of-pocket cost of attending a more expensive private school will generally rise. If students could borrow as much as they want rather than the fixed dollar limit now allowed, this option would not necessarily affect relative prices since students could borrow enough to cover the same percentage of costs at either type of institution. In this case, the absolute difference in current costs would be reduced--a result that would probably favor private institutions. Of course, except for interest payments, GSLs do not--and would not even if the program were expanded-- alter the long-run cost difference between public and private institutions.

Ease of Administration

Changes in the GSLP that provide more benefits to middle-income and upper middle-income students are not likely to increase the administrative problems of the program, foremost of which is a high default rate on GSLs (12.5 percent in fiscal year 1977). 23/ In fact, if these students prove to have lower default rates, administering the GSLP could become easier.

U.S. Office of Education. Data on administrative costs were not available when this report was completed.

23/ This 12.5 percent default rate on GSLs excludes defaults resulting from deaths and disablements. Source: U.S. Office of Education.

Budget Visibility and Controllability

Guaranteed student loans are moderately visible in the budgetary process, but are not very controllable. Unlike tax expenditures, outlays for the GSLP (interest and default payments and administrative costs) 24/ are reported under the education function in the budget and are subject to the review and scrutiny given to other direct outlays. The federal government, however, is obligated to make interest and default payments for whatever volume of GSLs that lenders supply. In this respect, they are like education tax allowances. But since federal outlays for GSLs are only a fraction of the liquidity benefits provided by loans, each dollar of federal funds supports more than a dollar of student benefits. In contrast, each dollar of tax allowances and other types of grants costs the government more than a dollar when administrative costs are taken into account.

LOANS TO PARENTS

If the 1976 changes in the GSLP and increased incentives for banks to expand their volume of guaranteed student loans fail to promote enough student loans to satisfy the liquidity needs of middle-income families, another course of action might be to establish a loan program for parents. A loans-to-parents program would assist those families now unable to obtain a GSL. Such families may find it difficult to get GSLs because their incomes are too high for them to qualify for the federal in-school interest subsidy. Another reason is that banks may be reluctant to lend to students whose default rates are high and who are often difficult to locate when repayment is overdue. Loans to parents would also help families who need more liquidity than the annual maximum of $2,500 per student now offered under the GSLP.

A loans-to-parents program might offer loans of as much as $5,000 per year for each student the family has enrolled in a postsecondary institution if education expenses required this much borrowing. The repayment period could be set somewhere between 5 and 10 years, with monthly payments of interest and principal beginning immediately after the loan is made. Alternatively,

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24/ The Budget of the United States Government, Fiscal Year 1978, app., pt. I, p. 341.

if more relief while the student is in school is desired, repayment of principal could be postponed until some time after the student finishes college. An interest rate of between 8 percent and 10 percent could be charged, perhaps varying with the length of the repayment period. If no collateral were required, a federal guarantee would undoubtedly be needed to induce most private lenders to participate, and during periods of high interest rates, a supplemental federal interest payment to lenders might be necessary to insure an adequate supply of capital. Generally, though, private lenders might be more attracted to a guaranteed loans-to-parents program than to the current GSLP since loans to parents are likely to incur fewer administrative costs and a lower default rate than loans to students.

Although many middle-income and upper middle-income families have liquidity problems that make it difficult for them to pay large, lump-sum education costs, 25/ these families generally have sufficient incomes to make monthly payments on long-term education loans. In contrast, recently graduated students are less likely to have sufficient income to repay their GSLs.

Currently 17 colleges and universities participate in a coordinated system of "Parent Loan Plans." 26/ Under this program, nonguaranteed, nonsecured loans expected to average $4,000 a year are provided by the institutions to families with incomes generally between $20,000 and $60,000. Interest rate charges range between 8 and 8 1/4 percent. The repayment period is generally between six and eight years, with repayment of both interest and principal made in monthly installments beginning soon after the loan is made.

Cost and Distributional Efficiency

The federal cost of a loans-to-parents program would depend mainly on the size of supplemental interest payments to banks (if

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25/ The largest asset for most families is their house, and many homeowners are reluctant to apply for second mortgages.

26/ See Karen J. Winkler, "Private Colleges Weigh Loans To Parents Earning $20,000 to $60,000," Chronicle of Higher Education, March 21, 1977, p. 3. The Office of Education staff also provided information about this program.

the program's success required such payments) and on the number of defaults. If the interest rate charged to parents were significantly higher than the 7 percent rate now charged on GSLs, smaller supplemental interest payments would be needed during periods of very high interest rates. Federal interest payments for each dollar of loans to parents would also be less than under the current GSLP since under the program outlined above the government would not be assuming responsibility for the payment of interest charges while the student is in school.

The federal cost per dollar of loans to parents also might be expected to be lower than the $.24 per dollar of loans disbursed under the GSLP thus far, 27/ since default rates would probably be lower when parents rather than students are liable for loans.

The share of loans that would go to middle-income families under a loans-to-parents program is difficult to estimate. As in the case of the GSLP, the outcome would depend on which families decide to apply for the loans and on the decisions by banks regarding the amount of loans to make and to whom they will go. As indicated above, though, a loans-to-parents program could prove successful in satisfying the liquidity needs of those middle-income families who now qualify for GSLs but who cannot obtain these loans because of reluctance of banks to lend to students.

Fairness and Equity

Since all families in the target group would be eligible for the same amount of loan, a guaranteed loans-to-parents option would be considered fair by those who believe that education subsidies should be distributed equally among recipients. Those who maintain that subsidies should be distributed progressively might prefer a loans-to-parents program that reduced the amount of guaranteed loan that those with relatively high incomes could get.

Maintaining Institutional Diversity

As in the case of the GSLP, the effect of a loans-to-parents program on the cost differences between public and private institutions depends on the amount that a family borrows. A program

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27/ Source: U.S. Office of Education.

that offers annual per-student loans of as much as $5,000 would provide families with enough liquidity to completely finance costs at either type of institution in all but a few cases. If parents borrowed enough to cover the same percentage of costs at public and private institutions, the dollar difference in current costs would be reduced--a result that would probably favor private institutions. Of course, except for interest payments, a loans-to-parents program would not alter the long-run cost difference between public and private institutions.

Ease of Administration

A guaranteed loans-to-parents program is likely to be easier to administer than the GSLP. The default rate on loans to parents is likely to be less than the default rate on GSLs, and in the case of delinquent payments, parents are likely to be more easily located and contacted than are recently graduated students.

Budget Visibility and Controllability

A guaranteed loans-to-parents program would have about the same ranking as the GSLP in terms of budget visibility and controllability. Like the GSLP, federal interest payments, default payments, and administrative costs would be reported under the education function in the budget. The federal outlays for the program, therefore, would be more visible than the federal revenue losses resulting from a tax expenditure program. Like the GSLP, however, a loans-to-parents program would be an entitlement and thus less controllable than direct spending programs that can be subjected to a firm ceiling through the appropriations process.

TAX DEFERRALS FOR EDUCATION EXPENSES

Another way to provide additional aid to middle-income students and their families is to allow taxpayers to defer (or postpone) a portion of their tax payments to finance education expenses, including room and board as well as tuition costs. This type of tax allowance is essentially a loan which is made available through the tax system.

An example of one possible tax deferral plan is to allow the taxpayer to postpone the payment of as much as $1,500 of taxes per student each year while the student is in school, with a lifetime

maximum of perhaps $10,000. Repayments could be made in 10 equal installments, beginning a full year after graduation, and an interest rate of 7 percent could be charged. (This interest rate is the same as that charged to students under the GSLP.)

Cost and Distributional Efficiency

Table 8 shows that the start-up costs of this tax deferral program would be about $8.8 billion--substantially greater than that of the other options discussed above. 28/ The net annual cost, however, would become minimal after 10 or 15 years, when the program was in operation long enough for repayments to be in full swing. Thereafter, the Treasury's outflow would exceed its inflow (adjusted for interest payments) only to the extent of growth in the number of borrowers and delinquent payments. Since the 7 percent interest charge approximates the rate on long-term Treasury securities, the Treasury would have little or no net interest cost unless its borrowing costs rise.

Table 8 also shows the distribution of tax deferrals resulting from this plan. Approximately 53 percent of the deferred taxes would benefit families earning between $10,000 and $25,000. This program, thus, distributes funds to middle-income families somewhat more efficiently than do the unmodified tax credit or credit/deduction options but less efficiently than the expanded BEOG program. Like the other loan programs, though, the much larger average benefit (in the form of liquidity) provides more meaningful relief than that realized under these other programs.

Fairness and Equity

If one views tax deferrals simply as a means of distributing a subsidy, then tax deferrals may be considered equitable to the extent that they allow some people to obtain loans that otherwise might not be available to them. Large tax deferrals, however, provide larger loans to high-income taxpayers who have a sufficient tax liability to take full advantage of the deferral. Thus those who believe that subsidized loans for education purposes

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28/ If it is decided that start-up costs should be lower, the size of the deferral could be reduced.

TABLE 8. DISTRIBUTION OF BENEFITS OF A TAX DEFERRAL PLAN PERMITTING POSTPONEMENT OF $1,500 OF TAXES ANNUALLY PER STUDENT a/

	Adjusted Gross Income Class (Dollars in Thousands)			
	0-10	10-25	25+	All Groups
Aggregate Benefits (Dollars in Millions)	417	4,648	3,767	8,832
Percentage of Total Benefits	4.7	52.6	42.7	100
Average Tax Deferral Per Eligible Student (Dollars)	286	897	1,278	911

a/ CBO estimate based on data from the U.S. Bureau of the Census; data from the U.S. Office of Education, National Center for Education Statistics; data supplied by Joseph Froomkin, Inc.; and tax data published by the U.S. Department of the Treasury, Internal Revenue Service.

should be distributed equally among all recipients might consider tax deferrals less equitable than subsidized loans that do not depend on the individual's tax liability.

Maintaining Institutional Diversity

This tax deferral plan would provide the same amount of liquidity to students attending private and public institutions whose charges for tuition, room, and board total at least $1,500; in this case the plan would not change the absolute difference in the current costs of attending these two types of schools. A $1,500 tax deferral, however, would produce greater percentage reductions in the current costs of attending public institutions that charge less than private ones and therefore would result in a relative increase in the current costs of attending most private institutions. (At some public institutions, the tax deferral might finance education costs completely.) Of course, except for interest payments, a tax deferral does not alter the long-run cost differential of high- and low-cost schools because the tax loan eventually must be repaid.

Ease of Administration

A tax deferral for education expenses would be more difficult to administer than a general education tax credit or credit/deduction plan with similar eligibility limitations since a tax deferral plan would involve more recordkeeping. For example, the specific option described above would require records to be kept by the IRS for 15 years or so to insure that the entire tax loan is repaid. If the payback period were shortened to avoid this shortcoming, the benefit to taxpayers would be reduced accordingly.

At present, records are generally kept in the IRS computer system for only three years. (Records going back more than three years generally are not maintained in the system but are sent to Federal Record Centers, which are less accessible.) For the IRS effectively to monitor a tax deferral program with a long payback period, the Service would need ready access to records for a period much longer than three years. Substantially increasing the recordkeeping capabilities of the IRS computer system would be

costly. The recordkeeping chore would be further complicated by the fact that taxpayers change residences frequently. 29/

Budget Visibility and Controllability

A tax deferral for higher education expenses ranks low in terms of budget visibility and controllability. In this respect it is like a tax credit, a credit/deduction option, and other tax expenditures that have not yet become subject to as much review and scrutiny as direct outlays and which, because they are entitlement programs that provide subsidies to all who qualify, are not subject to fixed ceilings on appropriations.

In addition, as in the case of other loan programs, the actual magnitude of tax deferrals tends to be less visible once the program has been in effect for some time and repayments begin to offset new deferrals.

29/ During the 1970-1975 period, 41.3 percent of the population four years and older changed residences within the United States. Source: U.S. Bureau of the Census, Current Population Reports, Series P-20, no. 285.

APPENDIXES

APPENDIX A. BRIEF DESCRIPTION OF TAX EXPENDITURES AND OTHER STUDENT AID PROGRAMS 1/

Federal aid to students is provided in the form of tax expenditures, grants, direct loans, and loan guarantees. Table A-1 lists the major programs.

The Exemption for Student Dependents allows a student to be claimed as a dependent for tax purposes even if he would otherwise be ineligible because he is over 19 years of age or has an adjusted gross income greater than $750. This tax provision benefits families who have tax liabilities and children with earnings. The value of each $750 personal exemption is $525 for families with a top marginal tax rate of 70 percent and $150 for families taxed at the median marginal rate of 20 percent. In addition to a $750 exemption, a $35 personal tax credit can be claimed for each student.

The Exclusion of Fellowships and Scholarships benefits those students who have taxable income or whose spouses have taxable income. The value of this exclusion varies with the size of the award and with the marginal tax rate of the taxpaying unit.

The Exclusion of G.I. Bill Education Benefits aid those veterans who choose to attend school. The benefits of this

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1/ Tax expenditures for higher education are discussed more fully in Committee on the Budget, U.S. Senate, Tax Expenditures: A Compendium of Background Material on Individual Provisions, 94:2 (1976). Federal programs of direct assistance for higher education are described in House Committee on Education and Labor and the Senate Committee on Human Resources, A Compilation of Federal Education Laws: As Amended Through June 30, 1977, 95:1 (1977). See, also, Congressional Budget Office, Postsecondary Education: The Current Federal Role and Alternative Approaches (February 1977); Veterans' Administration, Federal Benefits for Veterans and Dependents (January 1977); and Congressional Budget Office, Social Security Benefits for Students (May 1977).

TABLE A-1. MAJOR STUDENT AID IN THE FORM OF TAX EXPENDITURES AND FEDERAL OUTLAYS a/

Tax Expenditures	Direct Outlays
Exemption for Student Dependents	Basic Educational Opportunity Grants
Exclusion of Fellowships and Scholarships	Supplemental Education Opportunity Grants
Exclusion of G.I. Bill Education Benefits	Work/Study Programs
Exclusion of Student Social Security Benefits	National Direct Student Loans
	Guaranteed Student Loans
	G.I. Bill Education Benefits
	Student Social Security Benefits

a/ The budgetary costs of these programs and their distribution among income groups are presented in Tables 1 and 2 of the text.

exclusion are distributed among income groups in approximately the way actual payments are distributed except that the value of the exclusion will vary with the marginal tax rate of the recipient.

The Exclusion of Student Social Security Benefits assists those families in which the head of household is disabled, retired, or deceased, and in which there is a student 18 to 21 years old. The benefits of this tax exclusion are distributed among income groups in approximately the way student social security payments are distributed except that those in somewhat higher income groups will benefit somewhat more because of their higher marginal tax rates.

Other Tax Expenditures than those discussed above assist students indirectly by providing aid to educational institutions. These include the deductibility of gifts and bequests to educational institutions, the exclusion of unrealized capital gains on these charitable contributions, the deductibility of state and local taxes used for higher education, and the exemption of interest on state and local higher-education borrowing. Aside from tuition charges, charitable contributions and nonfederal government support are the primary sources of finance for institutions. To the extent that tax expenditures promote charitable contributions or make it easier for states and local governments to raise revenues, they assist students by allowing institutions to rely more on these sources of finance than on increases in tuition and other charges.

Basic Educational Opportunity Grants were established in 1972 to provide aid to students who are carrying at least half of a normal full-time load at colleges, postsecondary vocational schools, and technical/trade institutions. Student eligibility is based on need as determined by an annually reviewed formula that takes into account such factors as family income, assets, taxes, number of wage earners, and family size. The amount of each qualified student's grant is equal to the lesser of (1) $1,800 minus the family's expected contribution 2/ or (2) one-half the cost of attendance. Eligible students may receive basic grant

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2/ Appropriations for fiscal year 1978 effectively reduce the maximum award from $1,800 to $1,600. A family is expected to contribute 20 percent of its discretionary income up to $5,000 and 30 percent of discretionary income above $5,000.

awards for four academic years although eligibility is sometimes extended to five years.

Supplemental Educational Opportunity Grants (formerly called Educational Opportunity Grants) were established in 1965. These funds flow through institutions to students of exceptional financial need as determined by the institutions under national criteria. The size of the grant is based on the student's financial need and ranges from $200 to the lesser of (1) $1,500 per academic year or (2) one-half the total financial aid provided to the student by the institution.

The College Work/Study program was started in 1965 to assist financially needy students through part-time employment. Together with Supplemental Educational Opportunity Grants and National Direct Student Loans (discussed below), they form "packages" of aid by which institutions assist students. Grants to institutions are authorized for partial reimbursement of wages paid to students participating in a work/study program in public or private nonprofit organizations. Currently federal funds pay 80 percent of the student's wages, with the remainder being paid by the institution, the employer, or some other donor.

National Direct Student Loans were established in 1958 and provide long-term, low-interest funds to needy students at eligible postsecondary institutions. For this purpose, a revolving loan fund is created at each institution with 90 percent of the capital provided by the federal government and 10 percent by the institution. Loans bear 3 percent interest generally beginning nine months after the student ceases at least part-time attendance.

The Guaranteed Student Loan program was established in 1965 to help students borrow from private lenders to apply for training at colleges, universities, and vocational schools. Loans carry a 7 percent interest charge to the student and are either guaranteed by a state or private nonprofit agency or insured by the federal government. A maximum of $2,500 per academic year ($5,000 for graduate training) may be applied for in most states if the education costs warrant borrowing this amount. Total loans outstanding may not exceed $10,000 for undergraduates and vocational students or $15,000 for students who extend their borrowing for graduate study. The federal government pays the interest for eligible students while they are in school and during a 12-month grace period following completion or withdrawal from school. Any

student whose adjusted family income is less than $25,000 (this corresponds to an adjusted gross income of about $31,000) is automatically eligible for the "in-school" subsidy. Over 95 percent of all borrowers receive this subsidy.

The G.I. Bill that currently provides virtually all of the veterans' education benefits was enacted in 1966 and covers those who served during the period February 1955 through December 1976. It grants up to 45 months of benefits for veterans enrolled in approved courses of instruction. Under this program, the veteran receives a monthly education assistance allowance that is intended to meet in part living expenses as well as education costs. The amount of the allowance depends on the number of dependents the veteran has and on whether school attendance is full time or part time. Currently those with no dependents who attend school full time receive $310 per month. Eligibility for these benefits extends for a period of 10 years after separation from service.

The most recent education program assisting military personnel was enacted in October 1976 and covers those entering the service after December 1976. The new program differs from the previous ones in that those wishing to participate must make contributions while they are in the service. The federal government matches each dollar of a participant's contribution with $2 of government funds.

Social Security Student Benefits were begun in 1965 and are paid to 18-to-21-year-old, unmarried, full-time student dependents of dead, disabled, or retired workers. Currently about one-eighth of all full-time enrolled 18-to-21-year-old students draw such benefits, averaging over $1,900 a year. Social security student benefits are not needs tested; rather the benefit is simply calculated as half that paid to a retired (or disabled) worker and three-fourths of the amount that a deceased worker would have received as retirement benefits. But 43 percent of the student beneficiaries receive less than the formula amount because of the family maximum rule that, in general, restricts total family benefits to no more than 175 percent of the worker's benefit.

APPENDIX B. EDUCATION TAX ALLOWANCES AND TAX EQUITY

Education tax allowances raise issues about the tax equity among individuals similarly situated (horizontal equity) and among taxpayers with different incomes (vertical equity). Education expenses do reduce the amount of income that can be used for other purposes, but it is not clear that such expenses represent the kind of reduction in ability to pay taxes that is normally taken into account in the tax code. The implications of education tax allowances for tax equity depend on what view of this issue is adopted.

In theory, involuntary and unexpected personal expenses that are extraordinarily large relative to income have a greater impact on ability to pay taxes and thus may have more claim to be treated as legitimate allowances against taxes. Casualty losses and extraordinary medical expenses are good examples. A person generally has little control over these outlays; 1/ they usually are unforeseen and sometimes are catastrophically large. Because of the nature of these expenses, the tax allowances provided for them receive fairly wide support as measures that improve tax equity. They help to relieve hardships that would arise from the strict application of a tax on economic income.

It is not clear that education expenses resemble casualty losses and medical expenses closely enough to warrant special tax allowances for tax equity purposes. Like an expenditure for medical care, an expenditure for tuition may be viewed by many taxpayers as a duty, a high-priority expense to be borne for the benefit of one's children or other dependents. As such, they may be considered semi-involuntary in nature and deserving of a tax allowance on the grounds that, to some extent, they represent a nonvoluntary reduction in ability to pay taxes. But they also resemble other semi-involuntary expenses, such as those for food and shelter, for which no deduction is provided. Moreover, education expenses differ from medical expenses and casualty losses in that the need to finance an education can almost always be anticipated far in advance. Finally, it may be argued that

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1/ Some medical expenses, such as those incurred for face-lifting and hair transplants, may be viewed as voluntary, however.

education expenses are inherently a more personal type of consumption than are medical expenses and thus should not be given any tax allowance. 2/

If education expenses are not considered to be a legitimate offset to taxes, then the adoption of an education tax allowance will worsen both horizontal and vertical equity. Horizontal equity will be adversely affected since two families with the same income, wealth, and number of children will be subject to different tax liabilities if one has children in college while the other does not. 3/ Vertical equity (fair treatment among taxpayers who differ only in income) will also suffer since the progressivity of the tax structure will depend in part on the number of students in a family. On average, taxpayers with children in college are wealthier than most other taxpayers; thus the adoption of an education tax credit will also make the tax structure less progressive overall. Some may view reduced progressivity as a desirable reform, but it could be provided in a more straightforward way by altering the tax rate schedule rather than by providing allowances for education expenses.

If, however, one adopts the opposing view that some tax allowance for education expenses is necessary to achieve equity among taxpayers based on their ability to pay taxes, the only question left is the form that the allowance should take. A tax deduction seems more consistent with this view than a credit.

In our tax system, expenses that reduce the ability to pay, such as casualty losses or unusually high medical expenses, usually take the form of deductions. In this way, the relationships among taxpayers with different incomes but the same ability to pay taxes are not modified. A credit, by contrast, could leave a low-income taxpayer with modest education expenses better off

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2/ For a discussion of the relation between education tax allowances and taxpayer equity, see John K. McNulty, "Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Personal Costs of Higher Education," California Law Review, vol. 61 (January 1973), pp. 36-42.

3/ If education tax allowances are focused on middle-income families with children in school and are financed by higher taxes on middle-income families, the result is a transfer of income from one group of middle-income families to another.

than someone with higher income and more education expenses even though it is stipulated that the education expenses have left them both with the same ability to pay taxes.

If, for example, Taxpayer A has income of $22,000 and education expenses of $2,000 while Taxpayer B has income of $25,000 and education expenses of $5,000, both have $20,000 left after these expenses with which to pay taxes. If education expenses are deductible for tax purposes, both A and B would pay the same tax. But if instead a credit is given for some portion of the education expenses, Taxpayer A would end up paying less than Taxpayer B even though it is assumed that both have the same ability to pay. This example is elaborated in Table B-1.

Some tax theoreticians have advocated education tax allowances not on the basis of ability to pay taxes but rather to perfect the definition of taxable income. 4/ The tax law now allows businesses to deduct certain expenses incurred in the production of income. These include depreciation costs on capital investment. It may be argued that the expenses of obtaining a college education, at least in part, can also be viewed as costs associated with the production of future income--an investment in human capital--and that the current definition of taxable income should be changed to allow deductions over time of the portion of college expenses considered to be a form of investment.

If this view is adopted, then tax allowances to students--who will earn the income resulting from the investment-- would seem appropriate while tax credits, deductions, or deferrals for parents would not. 5/ Deductions seem preferable because they reduce the tax base to which the progressive tax rates are applied. Thus, deductions do not affect the progressivity of the tax structure. In contrast, credits and deferrals of equal amounts reduce taxes otherwise due. This reduction is not proportional to the progressive tax structure and thus changes its progressivity.

4/ For example, see Richard Goode, The Individual Income Tax (Brookings Institution, 1976), pp. 80-92.

5/ Education expenditures by parents, relatives, or friends may be considered gifts, the value of which could be recovered free of income tax just as the cost of a depreciable asset acquired as a gift can now be written off against the recipient's income.

TABLE B-1. COMPARATIVE EFFECTS OF TAX CREDITS AND TAX DEDUCTIONS ON TAXPAYER EQUITY: IN DOLLARS

	Deduction		Credit	
	Taxpayer A	Taxpayer B	Taxpayer A	Taxpayer B
Income	22,000	25,000	22,000	25,000
Education Expenses	2,000	5,000	2,000	5,000
Deduction	-2,000	-5,000	*	*
Taxable Income	20,000	20,000	22,000	25,000
Tax before Credit	4,380	4,380	5,020	6,020
Credit (25%)	*	*	-500	-1,250
Net Tax	4,380	4,380	4,520	4,770

*/ Not applicable.